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No. 94-____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

WILLIAM CHANOFF, DAVID CHANOFF, RACHEL CHANOFF and HARRIET FINGEROTE,

Petitioners,

—v.—

UNITED STATES SURGICIAL CORPORATION, LEON HIRSCH, TURI JOSEFSEN, BRUCE C. LUSTMAN and MARIANNE SCIPIONE,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Dated: October 26, 1994

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QUESTIONS PRESENTED

1. Whether a corporate officer and director, after inducing a shareholder to refrain from selling his stock by means of, *inter alia*, materially false and misleading statements made personally to that shareholder, may escape liability under state law on grounds of federal preemption.

2. Whether a corporation and its officers, after inducing a shareholder to refrain from selling his stock by means of, *inter alia*, materially false and misleading statements disseminated to all shareholders, may escape liability under federal and state law—at the pleading stage—on the ground that the shareholder's claim for damages is too speculative to be actionable.

3. Whether the rule announced in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), should be applied to invalidate federal racketeering claims predicated on otherwise well-pleaded underlying violations of Rule 10b-5, the federal mail fraud statute, and the federal wire fraud statute, on the ground that the victims of those violations were not purchasers or sellers of securities.

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No. 94-____

WILLIAM CHANOFF, DAVID CHANOFF, RACHEL CHANOFF and HARRIET FINGEROTE,

Petitioners,

—v.—

UNITED STATES SURGICIAL CORPORATION, LEON HIRSCH, TURI JOSEFSEN, BRUCE C. LUSTMAN and MARIANNE SCIPIONE,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners William Chanoff, David Chanoff, Rachel Chanoff and Harriet Fingerote respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on July 28, 1994.

OPINIONS BELOW

The July 28, 1994 *per curiam* opinion of the court of appeals (App. A) is reported at 31 F.3d 66 (2d Cir. 1994).[1]

[1] All references to "App. __" are to the Appendices reproduced at the conclusion of this Petition pursuant to Rule 14.1(k). All references

The July 28, 1994 order of the court of appeals (App. B) affirming the March 15, 1994 judgment of the United States District Court for the District of Connecticut (App. D) is unreported. The district court's underlying January 4, 1994 Ruling on Motion to Dismiss (App. C) is reported at 857 F. Supp. 1011 (D. Conn. 1994).

JURISDICTION

The judgment of the court of appeals was entered on July 28, 1994. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

1. The Supremacy Clause of the United States Constitution provides, in pertinent part, that "the Laws of the United States . . . shall be the supreme Law of the Land." U.S. Const. art. VI, cl. 2.

2. Section 28(a) of the Securities Exchange Act of 1934 (the "1934 Act") provides, in pertinent part, that "[t]he rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb(a).

3. The Racketeer Influenced and Corrupt Organizations Act ("RICO") provides, in pertinent part, that "racketeering activity" means "any act which is indictable under any of the following provisions of title 18, United States Code: . . . section 1341 (relating to mail fraud), [or] section 1342 (relating to wire fraud)." 18 U.S.C. § 1961(1)(B).

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to "Cmplt. ¶ __" are to the numbered paragraphs of petitioners' Complaint, reproduced in Appendix E.

STATEMENT OF THE CASE

Petitioners William Chanoff, David Chanoff, Rachel Chanoff and Harriet Fingerote ("the Chanoffs"), are long-time shareholders of respondent United States Surgical Corporation ("USSC" or "the Company"), which is a publicly-traded Delaware corporation, headquartered in Connecticut, in the business of manufacturing and distributing surgical supplies. Petitioners were induced to retain their approximately 400,000 shares of USSC common stock, to purchase 2000 additional shares, and to borrow against their stock in margin accounts, all as a result of material misrepresentations and misleading statements of material fact made to them by USSC and four of its senior officers and directors, respondents Leon Hirsch, Turi Josefsen, Bruce Lustman and Marianne Scipione (the "Executives").

Petitioners brought this action pursuant to both federal and state law to redress the devastating financial losses and other damage they suffered as a result of respondents' fraud. Although the common law of both Connecticut and Delaware indisputably permits claims for damages to be brought by shareholders who were induced to retain their securities (rather than to purchase or sell) by misconduct of this nature, the district court dismissed all of petitioners' state law claims arising out of their status as "holders" of the Company's stock. Similarly, although the federal racketeering statute expressly permits treble damage claims predicated on underlying acts of wire and mail fraud—as to which no purchase or sale is required—the district court dismissed petitioners' RICO claim to the extent it arose out of their status as "holders" of USSC stock. The court of appeals then affirmed summarily, thereby improperly extending the rule of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), to petitioners' state law and RICO claims.

The Complaint

The Chanoffs' Complaint, filed on July 30, 1993 (App. E) outlines respondents' misconduct, and petitioners' resulting injuries, in copious detail. Beginning in early 1992, and continuing through April, 1993—while the Executives sold over 1.7 million shares of their own USSC stock for proceeds of more than $155 million—these same Executives made, and caused the Company to make, a series of statements that affirmatively misrepresented USSC's financial performance and prospects while concealing the fact that the Company was facing increasingly severe competition and, in response, had implemented a significant change to its method of distributing its products. Cmplt. ¶¶ 1, 21-30. That change—from a highly-touted, historically successful direct distribution system which relied on USSC's own in-house sales force to sell its products to hospitals and other end-users, to a "Just In Time" ("JIT") system utilizing non-employee, third-party distributors—was expected to and did create a temporary, unsustainable surge in the Company's sales and earnings, as the distributors purchased large initial stockpiles of supplies (later called the "pipeline fill" effect by analysts), followed by an inevitable and dramatic slump, as customers allowed their own inventories to deplete before reordering from the distributors. Cmplt. ¶¶ 24-25.

Some of respondents' false and misleading statements were publicly disseminated by means of USSC's Securities and Exchange Commission ("SEC") filings, press releases and the like; others were made personally and directly, in interstate telephone conversations and private letters sent through the United States mail, to petitioner William Chanoff, an 82-year-old former director of the Company, by respondent Scipione, a USSC director and its Vice President for Corporate Communications. Ms. Scipione did not merely remain silent about the increasing competition facing the Company, its decision to implement the JIT program, and the effects of that pro-

gram. Instead, she continually reassured Mr. Chanoff (whom she knew to be keenly interested in USSC's in-house sales force and convinced that it was the key to the Company's continued financial success) that the sales force was "doing well" and that USSC was "on course" (Cmplt. ¶¶ 46, 56, 62, 66-67, 78-80, 84, 88); she misled Mr. Chanoff as to the reasons for the Executives' personal stock sales (Cmplt. ¶¶ 59-60, 80); she actively dissuaded Mr. Chanoff from selling (or even hedging) any of his family's USSC's stock, as his stockbroker had recommended (Cmplt. ¶ 84); she stated publicly, during the first quarter of 1993, that she was "comfortable" with projections that USSC's net income per share that year would be "$3.00 plus or minus a few cents," compared with $2.32 for 1992 (Cmplt. ¶¶ 72-72); and she told Mr. Chanoff, in two personalized letters written in February and March of 1993, to expect the Company's sales to grow at the rate of 15% per annum. Cmplt. ¶¶ 74, 77.[2]

In reliance on respondents' false and misleading statements, the Chanoffs refrained from selling any of their USSC stock in 1992 or the first part of 1993, which they would have done had they known the truth. Cmplt. ¶¶ 20, 40, 49, 61, 64, 70, 84, 90. William Chanoff also purchased additional stock in October 1992, which he would not have done if he had known the truth, and William Chanoff, Rachel Chanoff and Harriet Fingerote borrowed against their USSC stock in margin accounts, thus leaving them particularly vulnerable to any sharp decline in price. Cmplt. ¶¶ 62-63, 96-99.

Ultimately, the truth emerged. On April 7, 1993—approximately three weeks after Ms. Scipione had last told Mr. Chanoff to expect sales to grow by 15% per annum—respondent Hirsch, USSC's Chairman, acknowledged that the Company had been "experimenting" with the JIT program for "approximately one year," that it had accelerated the program

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[2] In fact, as a result of the JIT program and related factors, the Company's 1993 sales were *down* 13% from 1992 and it suffered a 1993 net *loss* of $2.48 per share.

during the first quarter of 1993 (already concluded), and that the program would have a dramatic negative effect on the Company's sales and earnings, including "significantly reduced sales" in the second quarter (already begun) and the third quarter of 1993. Cmplt. ¶ 91. He also acknowledged that the purpose of the JIT program was to "put us in a more competitive position in dealing with our customers." *Id.*[3]

Not surprisingly, this disclosure caused the price of USSC's shares to plummet on the New York Stock Exchange ("NYSE"). The Company's common stock lost almost one-third of its market value in a single trading day, and has never recovered. Cmplt. ¶ 93. Moreover, petitioners were forced to liquidate much of their stock at its new low price to meet the margin calls resulting from the collapse. As for William Chanoff—who had looked to his USSC investment as his retirement security and legacy to his family—the debacle produced an immediate worsening of his diabetes and left him depressed and sleepless as he contemplated the possibility of losing his home and business and being unable to support his family. Cmplt. ¶ 96-99.

Based on these facts, the Chanoffs' Complaint alleged that respondents were liable to them under state law for fraud, fraud by nondisclosure, breach of fiduciary duties, negligent misrepresentation and negligence (Counts I-V); that respondents violated Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (Count VI);[4] that the Executives violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 15 U.S.C.

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[3] One week after the Company's "official" disclosure, Ms. Scipione admitted that the JIT program began in the first quarter of 1992 and became "heavy" in the fourth quarter—two quarters before the Company admitted its existence. Cmplt. ¶ 95.

[4] This claim was expressly limited to the 2000 shares of USSC stock that Mr. Chanoff purchased in October 1992. Cmplt. ¶ 142.

§§ 1962(c) and (d) (Count VII);[5] and that respondents violated Section 36-472 of the Connecticut Uniform Securities Act (Count VIII).

Proceedings Below

Respondents promptly moved to dismiss all of petitioners' claims pursuant to Fed. R. Civ. P. 12(b)(6), and obtained a stay of discovery pending the disposition of their motion. On January 4, 1994, the district court issued its Ruling on Motion to Dismiss (the "Ruling"), which dismissed all claims alleged by David Chanoff, Rachel Chanoff and Harriet Fingerote (none of whom had purchased or sold any USSC stock during the period of respondents' fraud) and all of William Chanoff's claims arising out of his status as a "holder," rather than a purchaser, of USSC stock.[6]

To the extent that petitioners' state law "holder" claims were based on the statements made personally to Mr. Chanoff by Ms. Scipione, the district court held them "preempted" by federal law. App. C-5. To the extent that the state law "holder" claims were based on respondents' publicly-disseminated statements, the district court held them defective on the ground that petitioners' damage claim was "too speculative to be actionable." App. C-9. The court also dismissed petitioners' RICO claim to the extent based on predicate acts

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[5] This claim was expressly predicated on respondents' numerous acts of underlying mail and wire fraud, as well as their underlying violations of Rule 10b-5. Cmplt. ¶¶ 146-47.

[6] The district court denied respondents' motion with respect to William Chanoff's fraud, fraud by nondisclosure, Rule 10b-5 and RICO claims, but only to the extent that those claims were based upon the 2000 shares of USSC stock that he purchased in October 1992. The court then consolidated those surviving claims with a previously-filed class action, *In re United States Surgical Corp. Securities Litigation*, No. 3:92-CV-375 (D. Conn.), brought under federal law on behalf of a class of purchasers of USSC stock from March 10, 1992 to June 11, 1993.

as to which they were neither purchasers nor sellers of securities. App. C-20-24. It neither discussed nor granted petitioners' request for leave to amend their Complaint.

On February 16, 1994, the district court granted petitioners' motion for entry of a final judgment pursuant to Fed. R. Civ. P. 54(b), and on March 15, 1994, judgment was entered. App. D.[7]

On July 28, 1994, the court of appeals issued its *per curiam* opinion, affirming the judgment below "for substantially the reasons stated by the district court." App. A-2. The court of appeals' judgment was entered the same day. App. B.

BASIS FOR FEDERAL JURISDICTION

The district court had jurisdiction over this action pursuant to 28 U.S.C. § 1331, in that petitioners alleged claims arising under the federal securities and racketeering laws, and pursuant to 28 U.S.C. § 1332, in that petitioners and respondents are citizens of different states and the matter in controversy exceeded the sum or value of $50,000, exclusive of interest and costs.

REASONS FOR GRANTING THE PETITION

The rule announced in *Blue Chip Stamps*, which limits private securities fraud claims under Rule 10b-5 to persons who purchased or sold securities as a result of the alleged fraud, was never intended to bar *state* law claims by persons who were fraudulently induced to *retain* their securities. Nor, until now, has any federal court ever applied the rule of *Blue Chip Stamps* to bar otherwise-valid state law claims by "holders" of securities.

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[7] On March 22, 1994, together with their notice of appeal, petitioners filed a notice voluntarily dismissing those of William Chanoff's claims which had survived the Ruling, without prejudice, pursuant to Fed. R. Civ. P. 41(a)(1)(i).

In this case, however, the analysis employed by the district court (and endorsed by the court of appeals) had exactly that effect. The decision below, if permitted to stand, would override venerable principles of common law as applied to securities fraud and make *Blue Chip Stamps* the law of land in all fifty states. It would also impose a purchaser-seller standing limitation on RICO claims, whether or not those claims are predicated on underlying violations of Rule 10b-5. This result is not only contrary to the intent of Congress, contrary to the intent of this Court when it decided *Blue Chip Stamps*, and in conflict with well-reasoned, reported decisions by other federal courts; it would be a public policy disaster, in that it would permit corporations and their officers to disregard their fiduciary duties to their existing shareholders, and affirmatively defraud those shareholders, with absolute impunity.

I. THIS COURT'S OPINION IN BLUE CHIP STAMPS WAS NOT INTENDED TO IMPOSE A PURCHASER-SELLER "STANDING" REQUIREMENT ON SECURITIES FRAUD CLAIMS BROUGHT UNDER STATE LAW.

The 1934 Act was never intended by Congress to occupy the field of securities regulation. To the contrary: the Act contains an express anti-preemption clause, section 28(a), which provides that "the rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb(a). As Congressman Rayburn explained in 1934, "This subsection reserves rights and remedies existing *outside* of those provided in the act." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 28 (1934) (emphasis added). *See also* 5 A. Jacobs, *Litigation and Practice Under Rule 10b-5*, § 11.01 at 1-297-99 (2d ed. 1990 rev.) (section 28(a) allows the "coexistence" of federal and state causes of action).

Because the remedies provided by the 1934 Act were never intended to be exclusive, it is well-settled that a defrauded

securities investor is free to seek redress for his injuries under state law, whether or not a concurrent federal cause of action is also available. It is equally well-settled that such an investor may recover damages under state law (where warranted), whether or not he succeeds, or could have succeeded, under federal law.[8]

In *Blue Chip Stamps*, this Court clearly acknowledged that the purchaser-seller rule it approved in that case had its genesis in the precise language used in Rule 10b-5 (which prohibits fraud "in connection with the purchase or sale of any security"), was premised on policy considerations peculiar to 10b-5 suits, and therefore was not intended to limit common law claims for fraud in the securities context. Indeed, Justice (now Chief Justice) Rehnquist took pains to explain that the "disadvantage" of the standing limitation adopted by the Court (that is, the danger that the purchaser-seller rule would "unreasonably prevent[ ] some deserving plaintiffs from recovering damages") is "attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law." 421 U.S. at 738, 739 n.9. Further, the Court noted, such remedies ordinarily are available under state law, as "it has long been established in the ordinary case of deceit that a misrepresentation which leads to a refusal to purchase or to sell is actionable in just the same way as a misrepresentation

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[8] *See, e.g., Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042 (11th Cir. 1987) (affirming trial court decision which permitted customers to recover against their brokerage firm for breach of fiduciary duty under state law but rejected their Rule 10b-5 claim for failure to establish the "reliance" element); *Huang v. Sentinel Government Sec.*, 709 F. Supp. 1290 (S.D.N.Y. 1989) (dismissing plaintiffs' Rule 10b-5 claims, primarily for failure to meet the federal "loss causation" test, but permitting plaintiffs to pursue their common law negligent misrepresentation claims); *Merrill Lynch, Pierce, Fenner & Smith v. Byrne*, 320 So.2d 436, 440-41 (Fla. Dist. Ct. App. 1975) (affirming customer's state law negligent misrepresentation judgment against stockbroker despite fact that customer had not established "scienter" and therefore could not have recovered under Rule 10b-5).

which leads to the consummation of a purchase or sale." *Id.* at 744.[9]

Thus, just as injured securities investors are routinely permitted to recover under state law despite an inability to establish the "reliance," "loss causation" or "scienter" elements of a Rule 10b-5 claim,[10] so have such investors routinely been permitted—until now—to recover under state law for fraud and related misconduct which induced them to retain their securities, rather than to purchase or sell, and therefore rendered them unable to meet the federal "standing" test for recovery under Rule 10b-5. *See, e.g., Blue Chip Stamps*, 421 U.S. at 738 n.9 (noting with approval that the plaintiff below had filed a state-court class action); *Ames v. Uranus, Inc.*, 1993 U.S. Dist. LEXIS 4629 (D. Kan. 1993) (permitting limited partners induced to retain their securities as a result of misrepresentations and omissions made by the general partner and its officers to pursue common law claims for fraud, "fraud by silence" and breach of fiduciary duty under Kansas law); *Gutman v. Howard Savings Bank*, 748 F. Supp. 254 (D.N.J. 1990) (permitting shareholders induced to retain their stock as a result of omissions and misrepresentations made by the issuer and its officers to pursue common law fraud and negligent misrepresentation claims under New York and New Jersey law); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215

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[9] Indeed, to the best of petitioners' knowledge, every state court which has squarely considered the issue has held that a plaintiff induced to retain his securities as a result of a defendant's fraud has the same right to sue as a plaintiff induced to purchase or sell securities. *See, e.g., Marhart, Inc. v. CalMat Co.*, Fed. Sec. L. Rep. (CCH) ¶ 96,655, at 93,096-98 (Del. Ch. 1992) (shareholders induced to hold their stock in reliance upon directors' misrepresentations stated valid cause of action); *Continental Insurance Co. v. Mercadante*, 222 A.D. 181, 184, 225 N.Y.S. 488, 491 (1st Dep't 1927) (bondholders induced to retain their bonds by defendants' false representations "cannot be denied redress because their conduct was inaction rather than action"); *Fottler v. Moseley*, 179 Mass. 295, 60 N.E. 788 (1901) (affirming judgment in favor of plaintiff induced to retain stock by fraud).

[10] *See* n.8, *supra*.

(S.D.N.Y. 1965) (permitting shareholders induced to retain their stock by misrepresentations made by a corporate director to pursue a common law breach of fiduciary duty claim under Washington and/or New York law).[11] *See also Weinberger v. Kendrick*, 698 F.2d 61 (2d Cir. 1982), *cert. denied*, 464 U.S. 818 (1983) (affirming district court's approval of class action settlement which included payments to persons induced to purchase securities, who had asserted Rule 10b-5 claims, and to persons induced to retain their securities, who had asserted pendent claims for fraud and breach of fiduciary duty under New York law).

In only one of the cases cited above did defendants even suggest that a federal court reject plaintiffs' otherwise-valid state law claims on standing grounds. That case was *Gutman v. Howard Savings Bank*, in which plaintiffs asserted common law fraud and negligent misrepresentation claims against Howard and several of its officers, alleging that they were induced to retain their Howard stock as a result of material omissions and misrepresentations made both publicly (in the issuer's quarterly reports) and privately (by corporate officers, in personal conversations with plaintiffs or their investment advisor). Defendants moved to dismiss the complaint, arguing, among other things, that plaintiffs could not state a common law securities fraud claim in the absence of an allegation that they "either bought or sold securities in reliance on defendants' alleged misrepresentations." 748 F. Supp. at 260.

The court made short work of this point. Judge Wolin first satisfied himself that the laws of both New Jersey (where Howard was incorporated and headquartered) and New York (where plaintiffs resided and where some of the misrepresentations were made) permit claims by defrauded holders of

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[11] *Stockwell* was decided prior to this Court's decision in *Blue Chip Stamps*, but long after the Second Circuit had adopted the same purchaser-seller rule in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

securities. 748 F. Supp. at 261-64. He then turned to, and forcefully rejected, defendants' contention that the "policy considerations" underlying *Blue Chip Stamps* should be applied to bar plaintiffs' state-law "holder" claims. *Id.* at 264-67.

Not only did this Court never intend the *Blue Chip Stamps* rule to apply to state law claims, Judge Wolin explained; the policy considerations underlying the rule have little force where, as in the case before him (and as in the case before this Court), many of defendants' misrepresentations were made directly and personally to plaintiffs, rendering the action an "ordinary case of deceit" well within the ambit of traditional common law fraud doctrine. 748 F. Supp. at 266. Moreover, the *Gutman* court pointed out, for a federal judge to "create a significant exception to the common law would manifest an unwarranted insensitivity to the [state] courts and legislature . . . , especially if that exception were based on policy considerations pertaining to a federal securities claim." *Id.* Thus, Judge Wolin concluded, "Although defendants are immune from 10b-5 liability, they should not be immunized from common law liability merely because their alleged fraud occurred in the securities market rather than the real estate or used car market." *Id.*

II. THE LOWER COURTS IN THIS CASE IMPROPERLY IMPOSED THE RULE OF BLUE CHIP STAMPS ON PETITIONERS' STATE LAW CLAIMS.

Under the laws of Connecticut (where USSC is headquartered and where respondents' misrepresentations were made) and Delaware (where USSC is incorporated), a plaintiff who has been induced to refrain from action by a defendant's fraud or related misconduct has the same right to sue for damages as a plaintiff who has been induced to take action.[12] Thus, nei-

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[12] *See, e.g., Egan v. Hudson Nut Products, Inc.*, 142 Conn. 344, 348, 114 A.2d 213, 215 (1955) (plaintiff may recover where fraudulent

ther the district court nor the court of appeals suggested, in this action, that the *Blue Chip Stamps* rule would be applied by the relevant state courts to bar the Chanoffs' "holder" claims. Nonetheless, relying upon an erroneous application of the doctrine of federal preemption, the district court dismissed all such claims arising out of the false and misleading statements made directly to William Chanoff by Ms. Scipione, then dismissed the remainder of petitioners' "holder" claims—those arising out of respondents' publicly-disseminated statements—for lack of cognizable damages. As is explained in more detail below, this analysis (endorsed without further comment by the court of appeals) effectively imposed the *Blue Chip Stamps* rule on all of petitioners' state law claims, and did so in a manner which, if followed elsewhere, would render it impossible for *any* shareholder, in *any* state, to seek redress for *any* misrepresentations by the issuer or its officers—whether public or private—that induced the shareholder to retain his securities.

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nondisclosure induced him "to enter into or refrain from entering into a transaction"); *Bouton v. Thompson*, 764 F. Supp. 20, 23 (D. Conn. 1991) (plaintiffs stated valid misrepresentation claim under Connecticut law against defendant who had covered up embezzlement of pension funds where complaint alleged that defendant "knew that [his] representations would prevent plaintiffs from taking action to recover the pension funds, and that plaintiffs relied on [defendant's] representations to their detriment"); *Marhart, Inc. v. CalMat Co.*, *supra*, Fed. Sec. L. Rep. (CCH) ¶ 96,655, at 93,096-98 (plaintiffs who held stock during 4-month period when CalMat directors issued misleading press releases, and relied upon defendants' misrepresentations when deciding "whether to buy, sell or hold shares," stated valid claim for breach of fiduciary duty); *Marhart, Inc. v. CalMat Co.*, 1992 Del. Ch. LEXIS 166, at *3-*4 (Del. Ch. 1992) (noting that directors owe duties to "stockholders, not prospective stockholders," and implicitly ruling that *only* "holders," as opposed to purchasers, had valid breach of fiduciary duty claims against CalMat directors).

A. The District Court's Preemption Analysis Was Improper.

In this case—as in *Gutman v. Howard Savings Bank* and *Stockwell v. Reynolds & Co.*—petitioners were induced to retain their securities in reliance upon (among other things) material misrepresentations, misleading statements and omissions made personally to them by an officer and director of the corporation in which they had invested. These facts are more than sufficient to make out the "ordinary case of deceit" that, as this Court noted in *Blue Chip Stamps*, has long been actionable at common law, regardless of whether the plaintiff was induced to act or to refrain from acting. 421 U.S. at 744. The district court in this case, however—unlike the *Gutman* and *Stockwell* courts—expressly held that "any claims based on defendant Scipione's direct statements . . . are preempted." App. C-12 n.5.

The court began its analysis with the unexceptional observation that it could not find petitioners' state law claims preempted by the federal securities laws unless it found an "actual conflict between the state and federal laws; that is, either that compliance with both state and federal law is impossible, or that the state law obstructs the congressional objectives underlying the federal law." App. C-4 (citing *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963)). Having accurately summarized the controlling principle, however, the district court proceeded to misread petitioners' Complaint and misapply federal law, all in order to find an "actual conflict" where, in reality, no such conflict exists. Since Ms. Scipione's misconduct consisted of her failure to disclose otherwise nonpublic information to William Chanoff—the court reasoned—and since "selective" disclosure of such information to the Chanoffs alone (or in advance of the market) would have violated the federal "tipping" laws, Ms. Scipione could not have complied with her obligations under state law without violating federal law. App. C-5-8. This analysis is triply flawed.

First, the court erred by presuming that the Chanoffs' state law claims "implicit[ly]" alleged some sort of right or entitlement to "selective" disclosure of material facts. App. C-7. In fact, no such allegation appears anywhere in petitioners' Complaint. The Chanoffs sought only that to which *every* USSC shareholder was entitled: full and fair disclosure of the material facts concerning the JIT program, the reasons for its implementation, and its effects. *See, e.g.*, Cmplt. ¶ 121 (alleging that respondents owed a duty of candor to petitioners "[b]y virtue of their status as USSC shareholders"). Since Ms. Scipione could easily have complied with her state law duties to petitioners—without running afoul of any federal law—by telling them and all other USSC shareholders the truth about the JIT program in a timely manner (a task she was well equipped to undertake in her capacity as Vice President for Corporate Communications), the district court should not have immunized her from state law liability on preemption grounds.

Second, the court erred by disregarding the fact that Ms. Scipione—like the other Executives—sold substantial quantities of her own USSC stock in 1992 on the basis of the very same adverse information she concealed from petitioners. *See* Cmplt. ¶¶ 1, 29, 38, 48, 58, 69, 83. Once she commenced this trading, Ms. Scipione was not merely free to disclose the truth about the JIT program to the public (including petitioners); she had an affirmative duty, under federal law, to do so. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969) (material information "must be effectively disclosed to the investing public prior to the commencement of insider trading in the corporation's securities"). Since federal law, like the laws of Connecticut and Delaware, required Ms. Scipione to do exactly what she stood accused of failing to do, the district court should not have relied on the doctrine

of federal preemption to protect her against petitioners' state law claims.[13]

Finally, and perhaps most importantly, the district court erred by completely ignoring the fact that Ms. Scipione did not merely withhold material information from Mr. Chanoff; she lied to him.[14] Had the court taken any notice of this issue, it could not have held that federal law preempted petitioners' state law claims based on Ms. Scipione's conduct.[15]

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[13] The district court found petitioners' argument on this point "not persuasive," explaining: "Even if defendants fraudulently misled the public by failing to disclose the information, this does not alter the fact that the information was nonpublic "inside" information at the time defendant Scipione communicated with William Chanoff. As such, it could not, under the federal law, be legally disclosed to William Chanoff alone." App. C-6. As noted above, however, petitioners do not argue, and have never argued, that they were entitled to selective or advance disclosure of any information. Moreover, had Scipione complied with her obligations under federal law from the outset—and publicly disclosed the truth about the JIT program *before* she commenced her insider trading—she would never have been faced with the dilemma that the lower court posited. *See generally* L. Loss, *Fundamentals of Securities Regulation* 735 (2d ed. 1988) (the federal policies governing insider trading cannot create a conflict between federal and state law because "there is nothing in Holy Writ that requires the insider to buy or sell"). Having chosen—presumably voluntarily—to sell her own USSC stock, Scipione should not be heard to complain that she was forced to defraud petitioners by the same federal tipping laws she had already so clearly violated.

[14] *See, e.g.*, Cmplt. ¶¶ 59-60, 80 (Scipione misled Chanoff as to the reasons for insider sales by Hirsch and others); 74, 77 (Scipione told Chanoff to expect a 15% growth rate in USSC's sales); 78-80 (Scipione specifically denied that USSC had experienced any negative developments); 84 (Scipione repeatedly dissuaded Chanoff from further consideration of selling his stock—which she knew had been recommended by his broker—by telling him that the Company was "on course" and the broker did not know very much about USSC); 88 (Scipione told Chanoff, the *same day* on which USSC later disclosed the JIT program and saw its stock drop by one-third, that she was "comfortable" with analysts' projections of strong 1993 earnings and that the Company had "nothing negative to report").

[15] The district court did acknowledge, at the outset of its Ruling, that "defendant Scipione specifically misled William Chanoff through

This question was squarely presented and correctly decided in *Stockwell v. Reynolds & Co.*, where plaintiffs alleged that they were induced to retain their Alside stock by material omissions and false representations made to them personally by an Alside director. 252 F. Supp. at 218. The director attempted to escape any common law liability by making the same argument made on behalf of respondent Scipione in this action:

> Defendant Carpenter urges that as a director of Alside he was under a legal duty not to disclose to the plaintiffs any inside information which might have been acquired by him as a director, and that, consequently, any failure on his part to disclose the true facts to the plaintiffs cannot constitute a breach of his fiduciary duty. Assuming, arguendo, that defendant is correct, *plaintiffs' complaint still states a cause of action since it alleges affirmative misrepresentations on Carpenter's part as well as nondisclosure of material facts.*

Id. at 220-21 (emphasis added).

As the district court correctly noted in its Ruling, there must be an "actual conflict" between state and federal law before state claims may be deemed preempted. App. C-4. There can be no such conflict with respect to Ms. Scipione's affirmatively false and misleading statements. Neither the federal tipping laws, nor any other federal law or doctrine, required Ms. Scipione to lie to Mr. Chanoff. Indeed, both state and federal law squarely prohibit misconduct of this nature. Thus, the fact that Ms. Scipione affirmatively misled Mr. Chanoff—a fact acknowledged but inexplicably disregarded by the district court—should have put her well outside of the

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false and misleading statements made to him in personal letters and telephone conversations." App. C-3. Nowhere in the Ruling, however, did the court discuss the implications of Scipione's affirmative misrepresentations. Instead, the court analyzed petitioners' claims as if Scipione's only delict was her failure to disclose material information to the Chanoffs.

reach of federal preemption doctrine and rendered her fully liable to petitioners under state law.

B. The District Court Erred In Finding Petitioners' Damage Claim Too Speculative To Be Actionable.

After disposing of all of petitioners' "holder" claims arising out of Ms. Scipione's personal communications with Mr. Chanoff on preemption grounds, the district court went on to reject the remainder of their "holder" claims—those arising out of respondents' false and misleading SEC filings, press releases, and other public statements—on the ground that petitioners "have not alleged cognizable injury or damage that could be construed as directly or proximately caused by the alleged misconduct." App. C-8. Specifically, the court explained, "the claims for [general] damages based on plaintiffs' failure to sell or hedge their stock are too speculative to be actionable." App. C-9.

Although the court's discussion on this point is not a model of clarity, it appears to have accepted the argument (strongly pressed by respondents below) that the Chanoffs would never be able to prove, with the requisite degree of certainty, when respondents should have told the truth about the JIT program, what the effect of that disclosure would have been on the market, and consequently what price the Chanoffs would have been able to obtain for their stock in the absence of respondents' fraud. "[I]n light of the difficulty in quantifying the value of earlier disclosure," the court explained, "the actual calculation of damages would be intractable at best." App. C-10.

It was plain error, petitioners submit, for the district judge to leap to such a conclusion in the context of a Rule 12(b)(6) motion made before any discovery had been permitted. As the court acknowledged, at the outset of its Ruling, "The issue on a motion to dismiss is not whether the plaintiff will prevail, but whether the plaintiff is entitled to offer evidence in support of his or her claims." App. C-2 (quoting *United States v.*

Yale New Haven Hosp., 727 F. Supp. 784, 786 (D. Conn. 1990)). Thus, even if it "appear[s] on the face of the pleadings that a recovery is very remote and unlikely," the court may not prejudge the evidence, but must allow plaintiffs to pursue it. *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974).

This principle is fully applicable to all elements of a plaintiff's claim, including any damages element.[16] Indeed, the same argument accepted by the district court in the instant case was made, but quickly rejected, in *Gutman*, *supra*, where—on facts strikingly similar to those alleged by the Chanoffs—Judge Wolin ruled that plaintiffs were not required, in their initial pleading, to "specify the number of shares they would have sold if defendants had or had not told them certain things." 748 F. Supp. at 260. In the instant action, the district court apparently lost sight of this principle and, in so doing, badly overstepped its authority under Rule 12(b)(6). Instead of allowing petitioners to take discovery and prove their well-pleaded damages claims, the court improperly substituted its own opinion as to the ultimate feasibility of that task.[17]

Moreover, the court significantly overestimated the intrinsic "intractability" of the Chanoffs' damages claim. App.

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[16] *See, e.g., Zeller v. Bogue Electric Mfg. Corp.*, 476 F.2d 795, 803 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973) (despite formidable evidentiary difficulties posed by plaintiff's complex damages theories, "the judge should have allowed him to try"); *Whitbread (US) Holdings, Inc. v. Baron Philippe de Rothschild, S.A.*, 630 F. Supp. 972, 979-81 (S.D.N.Y. 1986) (where plaintiff stated a valid Rule 10b-5 claim, the practical difficulties it would likely face in establishing the price it would have paid for its stock had it not been misled by defendants did not warrant dismissal at the pleading stage).

[17] Contrary to the district court's characterization, petitioners did not "concede," at oral argument, that "there is no one precise point at which defendants' duty to disclose information concerning the JIT program attached." App. C-10. Instead, counsel explained she could not tell the court precisely when that information should have been disclosed because "we have had no discovery as yet."

C-10. The task of determining when adverse information became sufficiently material to require disclosure is a familiar one for the federal judiciary, and does not cause undue difficulty. *See, e.g., Abrahamson v. Fleschner*, 568 F.2d 862, 877-79 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978) (where limited partners in an investment partnership claimed that they would have withdrawn from the partnership earlier, had defendants told them the truth about its investments in risky unregistered securities, Judge Timbers instructed the district court to determine "at what point defendants' representations became fraudulent," then to compute plaintiffs' net losses "after the point when the defendants' representations became fraudulent").

Similarly, the "actual calculation" of petitioners' general damages, once a disclosure date is determined, would be relatively simple. Those damages would be measured by the difference between the price for which the Chanoffs could have sold their USSC shares—had respondents promptly and publicly disclosed truthful information concerning the JIT program and related issues—and the approximately $30 per share with which they were left, in April 1993, after defendants belatedly told the truth.[18] While this calculation would indeed

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[18] *See Minpeco, S.A. v. Conticommodity Services, Inc.*, 676 F. Supp. 486, 495 (S.D.N.Y. 1987) (where plaintiffs both opened and closed their silver futures positions in a manipulated market, their damages would consist of the difference between "the non-artificial element of the opening price and what the closing price would have been in the absence of manipulation"). Indeed, under Delaware and Connecticut law, the Chanoffs would arguably be entitled to measure their damages from the *highest* unmanipulated price they could have obtained for their stock within a reasonable time after disclosure should have been made. *See Du Pont v. Delaware Trust Co.*, 364 A.2d 157, 161 (Del. Ch. 1975) (where defendant failed to transfer stock to plaintiff in breach of fiduciary duty, plaintiff was entitled to damages measured by the "highest value" of the shares during the period of deprivation); *In re New York, N. H. & H. R. Co.*, 64 F. Supp. 487, 491 (D. Conn. 1945) (where defendants' conversion caused plaintiff to "lose a ready market," plaintiff was entitled to recover the market value of his property at the time of the conversion "or the

require the fact-finder to answer a hypothetical question—and determine what the unmanipulated market price of USSC's stock would have been on a particular date—this question is routinely asked, and just as routinely answered (usually with the aid of experts) in a wide variety of cases.

For example, in a typical Rule 10b-5 "fraud on the market" action, where damages are measured by the "out of pocket" rule, the fact-finder must determine what the market price of plaintiffs' stock would have been, absent defendants' fraud, on the date(s) of purchase. *See, e.g., Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 576-78 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982) (jury properly found, based in part on expert testimony, that defendants' fraud inflated market price of Solitron stock by 33% in 1967-68 and 54.2% in 1968-69). Similar determinations are made in commodities cases. *See, e.g., Minpeco, supra*, 676 F. Supp. at 495 (noting that Minpeco's expert had formed an opinion as to the unmanipulated price of silver on the relevant dates, and stating that "a jury could reasonably award lost profits" based on the expert's work).

In short, the calculations required to determine petitioners' general damages in this action are no more difficult—conceptually or practically—than the calculations routinely undertaken by courts and juries in a wide variety of securities and commodities fraud cases. Moreover, fraud damages need not be calculated to the penny; as the district court noted, they need only be "estimated" with "reasonable certainty." App. C-9. *See Morrell v. Wiley*, 119 Conn. 578, 584, 178 A. 121, 123 (1935); *Pacelli Bros. Transp. Inc. v. Pacelli*, 189 Conn. 401, 411, 456 A.2d 325 (1983). Indeed, it is well-settled, under both federal and Connecticut law, that a fraud plaintiff may not be denied redress simply because (as is frequently the case) defendant's misconduct has made a precise calculation impossible:

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highest intermediate value between the notice of the conversion . . . and a reasonable time thereafter").

> Any other rule would enable the wrongdoer to profit by his wrongdoing at the expense of his victim. It would be an inducement to make wrongdoing so effective and complete in every case as to preclude any recovery, by rendering the measure of damages uncertain. . . . The most elementary conceptions of justice and public policy require that the wrongdoer shall bear the risk of the uncertainty which his own wrong has created.

Bigelow v. RKO Radio Pictures, Inc., 327 U.S. 251, 264-65 (1946).[19]

The same principle applies here. It was respondents who, through their material misrepresentations and omissions, induced the Chanoffs to retain their USSC stock and prevented the market from accurately reflecting the value of that stock throughout the period of their fraud. "The most elementary conceptions of justice and public policy," therefore, demand that respondents not be permitted to escape liability for their misconduct (much less at the pleading stage) on the ground that it would be difficult for the Chanoffs to prove when, and at what price, they would have sold their stock in the absence of that fraud.

C. The District Court's Opinion, If Permitted To Stand, Would Render Corporations And Their Officers Immune From Any State Law Liability For Fraud Which Induces Existing Shareholders To Retain Their Stock.

There are only two ways for a corporation and its officers to communicate false or misleading information to share-

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[19] *Accord, Story Parchment Co. v. Paterson Parchment Paper Co.*, 282 U.S. 555, 562-63 (1931); *Eastman Kodak Co. v. Southern Photo Materials Co.*, 273 U.S. 359, 379 (1927); *Crowell v. Palmer*, 134 Conn. 502, 511, 58 A.2d 729, 733 (1948) ("[m]ere difficulty in the assessment of damages is not a sufficient reason for refusing them where the right to them has been established") (citation omitted).

holders: privately (as Ms. Scipione did in this case through the statements she made personally to William Chanoff by telephone and mail) or publicly (as respondents did in this case through their SEC filings, annual and quarterly reports, and press releases). If the shareholder retains his stock in reliance on the false and misleading information—such that he lacks standing to sue for damages under Rule 10b-5—then he must turn to state law, unencumbered by the *Blue Chip Stamps* rule, for redress. If, on the other hand, he cannot challenge either the private or the public misrepresentations under state law, then he has no hope of redress.

In this case, petitioners were the victims of both private and public misrepresentations, but were told by the lower federal courts that they had no right, as "holders," to pursue any state law remedies for their injuries. Moreover, the analysis employed by the district court (and endorsed by the court of appeals) was generic in its application and effect. That is, the "preemption" analysis utilized to dismiss petitioners' "holder" claims arising out of Ms. Scipione's personal communications with Mr. Chanoff would apply with equal force to *any* state law claims brought by shareholders induced to retain their stock in reliance on personal communications with corporate officers. Similarly, the "speculative damages" analysis utilized to dismiss petitioners' "holder" claims arising out of respondents' publicly-disseminated misrepresentations would apply with equal force to *any* state law claims brought by shareholders induced to retain their stock in reliance on false or misleading public statements.

Neither the district court nor the court of appeals discussed the broader implications of the Ruling for defrauded shareholders. It takes but a moment's reflection, however, to recognize that if the Chanoffs—defrauded by a publicly-traded corporation and its top officers, by means of both affirmative misrepresentations and material omissions, made both privately and publicly, and suing under the laws of states which clearly would not apply the *Blue Chip Stamps* rule—are

unable to pursue any state law claims as "mere holders" of securities, then no "holder" will ever be able to overcome the disabilities posited by the lower courts in this action. In short, the effect of the decision in this action—if permitted to stand and followed elsewhere—will be to impose the rule of *Blue Chip Stamps* on the laws of all fifty states, and to immunize corporations and their officers from any state law liability for fraud which induces shareholders to retain their securities.

III. CORPORATIONS AND THEIR OFFICERS SHOULD NOT BE IMMUNIZED AGAINST STATE LAW LIABILITY FOR FRAUD PERPETRATED ON SHAREHOLDERS.

As this Court acknowledged in *Blue Chip Stamps*, a "great majority" of commentators, together with the SEC itself, opposed the adoption of the purchaser-seller rule on policy grounds, fearing not only that it would "unreasonably prevent[ ] some deserving plaintiffs from recovering damages," 421 U.S. at 738, but also that the lack of a private damages remedy for fraud which induces a shareholder to retain his stock would remove a significant deterrent to this type of misconduct and lead to widespread corruption. *See, e.g.*, L. Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 Va. L. Rev. 268, 275-76 (1968).

This Court took those concerns seriously, remarking that the policy considerations it was called upon to weigh were "by no means entirely on one side of the scale." 421 U.S. at 749.[20] Moreover, as noted above, the Court ultimately pronounced itself comfortable with the purchaser-seller rule—for

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[20] Indeed, three members of the Court concluded that the purchaser-seller rule, even if applied only to Rule 10b-5 suits, would be bad public policy, and chastised the majority for exhibiting a "preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . with our own traditions and the intent of the securities laws." 421 U.S. at 762 (Blackmun, J., dissenting).

use in private Rule 10b-5 suits—only after assuring those concerned about its manifest disadvantages that "remedies are available to nonpurchasers and nonsellers under state law." 421 U.S. at 739 n. 9.

Were those state law remedies to become unavailable—as would be the case if the decision in this action is widely followed—there would be virtually no check upon the species of fraud perpetrated by respondents herein. Although SEC enforcement actions are not limited by the purchaser-seller rule, neither federal nor state regulators can be expected to uncover and redress every instance of fraud in the U.S. securities markets. Indeed, it is well-recognized that "[p]rivate litigation is an essential element in enforcing the rights of more than 50 million Americans who participate in the U.S. securities markets." *Securities Investor Protection Act of 1991: Hearing Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 102nd Cong., 1st Sess. 3 (1991) (testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission). Absent the availability of private damages remedies and the deterrent effect provided by such remedies, not only would many victims of fraud go uncompensated; the number of those victims would rise, to the ultimate detriment of investors and honest issuers alike. *Id.* at 4 ("[w]eakening safeguards against fraud could make investments more hazardous and less attractive to investors, thereby raising the cost of capital for businesses").

This Court obviously did not believe, when it decided *Blue Chip Stamps*, that it was giving corporations and their officers the green light to defraud existing shareholders with impunity. If the decisions of the lower federal courts in this action are permitted to stand, however, the most effective check upon this species of fraud—the private damages remedy under state law—could well disappear, to the incalculable detriment of innocent investors in every state and, ultimately, the U.S. markets.

IV. THE LOWER COURTS IN THIS CASE IMPROPERLY ATTEMPTED TO AMEND THE RICO STATUTE BY JUDICIAL FIAT.

As noted above, the district court dismissed *all* of petitioners' "holder" claims, including their RICO claim (to the extent predicated on the approximately 400,000 shares of USSC stock they were induced to retain). In order to reach this result, the court expressly agreed with respondents—and with the Fourth Circuit—that even though the RICO statute itself contains no purchaser-seller requirement, "where the plaintiff pleads a predicate 10b-5 violation, the 10b-5 standing requirement still stands." App. C-22 (citing *International Data Bank, Ltd. v. Zepkin*, 812 F.2d 149, 153 (4th Cir. 1987)).

Until now, *Zepkin* was the only appellate case holding that *Blue Chip Stamps* could be applied to invalidate a RICO claim predicated on underlying violations of Rule 10b-5 as to which the RICO plaintiff was neither a purchaser nor a seller. Three appellate cases, in two other circuits, had held squarely to the contrary.[21] Given that the Second Circuit has affirmed the dismissal of petitioners' RICO claim for "substantially the reasons stated by the district court," however, the circuits are now evenly split on this question.

In *Holmes v. Securities Investor Protection Corp.*, 112 S. Ct. 1311 (1992), this Court declined to resolve the precise

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[21] *Pelletier v. Zweifel*, 921 F.2d 1465, 1510-11 n.80 (11th Cir.), *cert. denied*, 112 S.Ct. 167 (1991) ("the standing requirements of the securities laws . . . do not apply to civil RICO actions based upon predicate acts of securities fraud"); *Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461, 1467 (9th Cir. 1990), *rev'd on other grounds sub nom. Holmes v. Securities Investor Protection Corp.*, 112 S.Ct. 1311 (1992) ("the purchaser or seller standing limitation that applies to 10b-5 actions does not apply to RICO claims based upon predicate acts that are alleged to be securities fraud"); *Warner v. Alexander Grant & Co.*, 828 F.2d 1528, 1530 (11th Cir. 1987) ("[t]he federal RICO statute has no requirement analogous to the 'purchase or sale' requirement of the federal securities laws").

issue presented here. All four concurring Justices, however, agreed that *Blue Chip Stamps* should *not* be applied to a RICO claim predicated on underlying Rule 10b-5 violations, and thus that a RICO plaintiff need not have been a purchaser or seller as to those predicates. As Justice O'Connor explained (in an opinion joined by Justices White and Stevens), the plain language of 18 U.S.C. § 1964(c) militates against any attempt by the courts to restrict recovery under RICO to those who would have had standing to bring a private civil suit based on each predicate act. 112 S. Ct. at 1323. Moreover, she observed, "the Judiciary may not circumscribe a right which Congress has conferred." *Id.* at 1327 (quoting *Blue Chip Stamps*, 421 U.S. at 748). Thus, she concluded, "RICO plaintiffs alleging predicate acts of fraud in the sale of securities need not be actual purchasers or sellers of the securities at issue." *Id.* at 1327. Justice Scalia, writing separately, agreed that "the purchaser-seller rule does not apply in civil RICO cases." *Id.*

Petitioners respectfully suggest that Justices O'Connor, White, Stevens and Scalia are correct. The decision in this case thus represents an improper attempt by the federal judiciary to "circumscribe a right which Congress has conferred." Indeed, the district court not only read *Blue Chip Stamps* into that portion of petitioners' RICO claim predicated on Rule 10b-5 violations; in order to dismiss the entire claim (except to the extent arising out of William Chanoff's purchase of USSC securities), it effectively imposed the same purchaser-seller rule on petitioners' otherwise well-pleaded mail and wire fraud predicates. *See* App. C-22 (acknowledging that petitioners alleged "additional predicate acts," including mail and wire fraud). This was clearly error.

Neither 18 U.S.C. § 1961(1)(B), which expressly permits RICO claims predicated on underlying violations of the federal mail and wire fraud statutes, nor any other provision of RICO, requires the plaintiff to have purchased or sold anything in order to recover treble damages. Nor do the texts of

the wire and mail fraud statutes themselves contain any purchaser-seller limitation. *See* 18 U.S.C. §§ 1341, 1343. Indeed, the courts have repeatedly held that the wire and mail fraud statutes may be violated without any purchase or sale by the victim of the scheme; all that must be shown is that he was deprived of "money or property." *See, e.g., Carpenter v. United States*, 484 U.S. 19, 25-26 (1987) (holding defendants criminally liable under mail and wire fraud statutes where, by trading on information in advance of its publication in a newspaper column, they deprived the newspaper of its "interest in the confidentiality of the contents and timing of the . . . column"). Thus, the RICO plaintiff's status as a "holder," as opposed to a purchaser or seller of securities (or anything else) should be irrelevant to the validity of his treble damages claim predicated on underlying violations of the mail and wire fraud statutes.[22]

"It is not for the judiciary to eliminate the private action in situations where Congress has provided it." *Sedima S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 499-500 (1985). In this case, the lower federal courts attempted to do just that when they rejected petitioners' efforts to recover under RICO for fraud which induced them to retain their securities. Absent review by this Court, they will have succeeded, improperly, in amending the federal racketeering statute by judicial fiat.

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22 *See Durham v. Business Management Associates*, 847 F.2d 1505, 1510-12 & n.13 (11th Cir. 1988) (absence of sale not relevant to mail fraud RICO predicate).

CONCLUSION

A wrong of the magnitude inflicted on petitioners herein cannot be incapable of legal redress. Unless this Court acts to correct the egregious errors committed by the district court and the court of appeals, however, petitioners—and many others induced to retain securities as a result of false and misleading statements made to them by the corporations in which they invested and/or corporate officers who owe them strict fiduciary duties—will find themselves with no remedy, under either federal or state law, for the fraud practiced upon them. Consequently, and for all of the reasons adduced above, petitioners respectfully request that their petition for a writ of certiorari be granted.

Dated: New York, New York
October 26, 1994

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APPENDICES

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APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 2068—August Term, 1993

(Argued: July 21, 1994 Decided: July 28, 1994)

Docket No. 94-7332

WILLIAM CHANOFF, DAVID CHANOFF, RACHEL CHANOFF and HARRIET FINGEROTE,

Plaintiffs-Appellants,

—v.—

UNITED STATES SURGICAL CORPORATION, LEON HIRSCH TURI JOSEFSON, BRUCE C. LUSTMAN and MARIANNE SCIPIONE,

Defendants-Appellees.

Before:

WINTER, MCLAUGHLIN, and JACOBS,

Circuit Judges.

Plaintiffs-appellants appeal from Judge Nevas's ruling granting defendants-appellees' Rule 12(b)(6) motion with respect to plaintiffs' claims of, *inter alia*, common law fraud and federal securities violations. We affirm.

BARBARA MOSES, New York, New York (Gregory A. Markel, Gary E. Weiss, Michael B. Carlinsky, Orrick, Herrington & Sutcliffe, New York, New York, Thomas J. Byrne, James T. Shearin, Pullman & Comley, Bridgeport, Connecticut, of counsel), *for Appellants*.

DALE A. SCHREIBER, New York, New York (Charles S. Sims, Lawrence S. Block, Proskauer Rose Goetz & Mendelsohn, New York, New York, of counsel), *for Appellees*.

PER CURIAM:

We affirm for substantially the reasons stated by the district court.

APPENDIX B

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Filed July 28, 1994
Docket No. 94-7544

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 28th day of July, one thousand nine hundred and ninety four.

Present:

HONORABLE RALPH K. WINTER,
HONORABLE JOSEPH M. MCLAUGHLIN,
HONORABLE DENNIS G. JACOBS,
Circuit Judges.

WILLIAM CHANOFF, DAVID CHANOFF,
RACHEL CHANOFF and HARRIET FINGEROTE,

Plaintiff-Appellants,

—v.—

UNITED STATES SURGICAL CORPORATION, LEON HIRSCH, TURI JOSEFSEN, BRUCE C. LUSTMAN and MARIANNE SCIPIONE,

Defendants-Appellees.

ORDER

Appeal from the United States District Court for the District of Connecticut.

This cause came on to be heard on the transcript of record from the United States District Court for the District of Connecticut, and was argued.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed.

APPENDIX C

UNITED STATES DISTRICT COURT

DISTRICT OF CONNECTICUT

Civil No.3:93CV01522(AHN)

WILLIAM CHANOFF, ET AL

v.

UNITED STATES SURGICAL CORP., ET AL

RULING ON MOTION TO DISMISS

The plaintiffs, William, David and Rachel Chanoff, and Harriet Fingerote ("plaintiffs"), bring this action against the defendants, United States Surgical Corporation ("USSC"), Leon Hirsch, Turi Josefsen, Bruce C. Lustman and Marianne Scipione (collectively "defendants"), alleging federal and state claims of securities fraud.

Presently pending is the defendants' motion to dismiss all counts of the complaint [doc. #18]. For the reasons that follow, the motion is granted with respect to Counts III, IV, V, VIII and David Chanoff's, Rachel Chanoff's and Harriet Fingerote's claims contained in Counts I, II, VI and VII. The motion is denied with respect to William Chanoff's claims contained in Counts I, II, VI and VII only insofar as he claims damages flowing from his purchase of 2000 shares of USSC stock.

STANDARD OF REVIEW

When considering a Rule 12(b)(6) motion to dismiss, the court is required to accept as true all factual allegations in the complaint and draw inferences from these allegations in the light most favorable to the plaintiff. *See Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974); *Easton v. Sundram*, 947 F.2d 1011, 1014-15 (2d Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 1943 (1992). Dismissal is warranted only if, under any set of facts that the plaintiff can prove consistent with the allegations, it is clear that no relief can be granted. *See Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984); *Frasier v. General Elec. Co.*, 930 F.2d 1004, 1007 (2d Cir. 1991). "The issue on a motion to dismiss is not whether the plaintiff will prevail, but whether the plaintiff is entitled to offer evidence to support his or her claims." *United States v. Yale New Haven Hosp.*, 727 F. Supp. 784, 786 (D. Conn. 1990), citing *Scheuer*, 416 U.S. at 232.

FACTS

With this standard in mind, the facts as alleged by the plaintiffs are as follows. The plaintiff William Chanoff is a former director of USSC; the plaintiffs Rachel Chanoff, David Chanoff and Harriet Fingerote are, respectively, William Chanoff's daughter, son and close friend. The individual defendants are directors and officers of USSC. As of January, 1992, the plaintiffs held approximately 400,000 shares of USSC stock. In the face of rising competition, USSC developed and implemented a third-party system of distribution (the "Just in Time Program," or "JIT") that radically changed the process by which USSC sold and distributed its products and had the following impact: 1) JIT caused a temporary surge in sales which was followed by a sharp slump, 2) the program required USSC to sell at discount to distributors thereby depressing long-term profit margin and 3) additional sales were lost due to the elimination of the direct interaction

between the USSC sales force and customers which had been an effective sales tool in the past.

Plaintiffs allege that USSC top executives caused USSC to conceal the competitive pressures and the implementation of the JIT program, as well as the financial impact of both of these factors. Plaintiffs contend that USSC not only omitted reference to these facts in their reports, but also affirmatively misled investors by denying suggestions that competition was a problem, continuing to refer to its direct sales efforts and predicting unrealistic future sales growth. In addition, plaintiffs allege that defendant Scipione specifically misled William Chanoff through false and misleading statements made to him in personal letters and telephone conversations. At the same time, defendants sold over 1.7 million shares of personally owned USSC stock.

As a result of the defendants' misrepresentation, plaintiffs allege that they refrained from selling or hedging USSC stock in 1992, and borrowed against their stock in margin accounts. In addition, plaintiff William Chanoff, purchased 2000 shares of USSC stock in October of 1992. On April 7, 1993, USSC acknowledged that it had implemented the JIT program and that the program would have a negative impact on the company's financial performance, particularly in the second and third quarters. After this disclosure, the stock lost almost 1/3 of its market value in a single day. Plaintiffs allege that after the disclosure, their stock holdings dropped in value from $50 to $12 million, and William Chanoff suffered emotional distress and an immediate decline in his health.

DISCUSSION

Defendants' arguments are threefold: (1) the state claims for the defendants' failure to disclose to William Chanoff should be dismissed as they are preempted by the federal securities laws, (2) the state claims should be dismissed on state law grounds and (3) the federal claims are not viable to the extent that they seek damages for shares neither purchased nor sold. These arguments shall be addressed seriatim.

I. *State Claims*

The plaintiffs' state claims are as follows: in Counts I and II, plaintiffs allege causes of action sounding in common law fraud; in Count III, plaintiffs allege state common law claims for breach of fiduciary duty; in Counts IV and V, plaintiffs allege state common law claims for negligent misrepresentation and negligence; and in Count VIII, plaintiffs allege breach of the Connecticut Uniform Securities Act, Conn. Gen. Stat. § 36-472. The state claims are based on both pendent and diversity jurisdiction. The defendants seek to dismiss all of these claims.

A. *Preemption*

The defendants argue that the plaintiffs' state claims for fraud, negligence and breach of fiduciary duty are preempted by the federal securities laws to the extent that the state claims are premised on the defendants' alleged duty to disclose inside information to William Chanoff. Such a duty, defendants argue, is directly inconsistent with federal securities law which prohibits selective disclosure and which is designed to foster an honest market in which investors have equal access to information. The court only partially agrees.

Generally, preemption is a question of congressional intent. Federal law preempts state law only when Congress acts to "occupy the field," or when the state claims are in direct conflict with the federal law. *Florida Lime & Avocado Growers v. Paul*, 373 U.S. 132, 142-43 (1963), *reh'g denied*, 374 U.S. 858 (1963). It is settled, however, that Congress did not act to occupy the field of securities; rather, the federal law preserved the states' broad powers to regulate areas within the field. *See, e.g., Baker & Watts v. Miles & Stockbridge*, 876 F.2d 1101, 1106 (4th Cir. 1989). Thus, to find preemption in this instance, the court must find actual conflict between the state and federal laws; that is, either that compliance with both state and federal law is impossible, or that the state law obstructs the congressional objectives underlying the federal law. *See Florida Lime & Avocado Growers*, 373 U.S. at 142-43; *Baker & Watts*, 876 F.2d at 1106; *Donmar v. Southern*

Nat'l Bank, 828 F. Supp. 1230, 1234-35 (W.D.N.C. 1993). It should be noted that the fact "[t]hat state common law proscribes certain behavior considered legal under the [federal act] is not dispositive," *Seoud v. E.F. Hutton & Co.*, 720 F. Supp. 671, 680 (N.D. Ill. 1989), because states are free to impose more restrictive standards than the federal standards. Indeed, courts should apply a presumption against preemption when the underlying state law concerns an area of traditional state regulation such as public health and safety. *See, e.g., H.P. Welch Co. v. New Hampshire*, 306 U.S. 79, 84 (1939). However, preemption is compelled where "states require behavior prohibited by federal enactments." *Seoud*, 720 F. Supp. at 680. In *Baker & Watts*, for example, the court found that while state common law claims are not expressly preempted by the federal securities laws, the plaintiff's state claim for indemnification was preempted as it was inconsistent with federal securities law which does not provide for such relief. *Baker & Watts*, 876 F.2d at 1107. *See also Donmar*, 828 F. Supp. at 1236-38 (finding common law claims of negligence and wrongful payment preempted by Federal Reserve Board Regulation J.)

Similarly, here, the court does not find that the plaintiffs' common law claims are per se preempted. Insofar as the claims are premised on the defendants' duty to disclose to the public and shareholders generally, such claims may be entirely consistent with the federal securities regulatory scheme.

The court agrees, however, that to the extent that plaintiffs' state claims are based on defendant Scipione's duty to disclose to William Chanoff during their personal exchanges, these claims are preempted by the federal securities laws which proscribe such selective disclosure. *Cf. In re Cady, Roberts & Co.*, 40 SEC 907; 1961 WL 3743, *6 (1961) (finding that insider's duty to abstain or disclose under federal securities laws superseded any fiduciary obligations broker/insider had to his customers). *See also Bateman Eichler v. Berner*, 472 U.S. 299 (1985); 105 S. Ct. 2622, 2630 (selective disclosure by insider often constitutes breach of

fiduciary duty to corporation); *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 169 (2d Cir. 1980) (investors have no absolute right to inside information, only to honest market in which investors have equal access to information); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc); *cert. denied*, 394 U.S. 976 (1969) (articulating "disclose or abstain" rule prohibiting trading on inside information).

Indeed, had defendant Scipione disclosed to William Chanoff the material nonpublic information that the plaintiffs allege she should have, and had William Chanoff taken action on the basis of that information, as the plaintiffs further allege he would have, both defendant Scipione and William Chanoff would have exposed themselves to liability under the federal laws against the tipping of inside information. *See Dirks v. SEC*, 463 U.S. 646, 664 (1983) ("elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself . . . .").

In response, the plaintiffs argue that concealment of information cannot be justified on the basis that defendants did not disclose information to other shareholders; rather, by selling stock while in possession of material inside information, plaintiffs contend, the defendants assumed the duty to disclose to all potential buyers. In essence, the plaintiffs' argue that the disclosures that defendant Scipione should have made to William Chanoff cannot be characterized as inside information, or "tipping," because defendants should have disclosed the same information to the public. Yet this argument is not persuasive: Even if the defendants fraudulently misled the public by failing to disclose the information, this does not alter the fact that the information was nonpublic "inside" information at the time defendant Scipione communicated with William Chanoff. As such, it could not, under the federal law, be legally disclosed to William Chanoff alone.

On this point, the SEC's opinion in *In re Cady, Roberts & Co.* is instructive. In that case, the SEC found that a broker violated the anti-fraud provisions of the 1934 Securities

Exchange Act in executing sales orders on discretionary accounts based on inside information. In a conceptual mirror image to the plaintiffs' arguments here, the broker in *Cady* contended that he was merely acting pursuant to his fiduciary duty to his customers which overrode any obligations he may have had to the public. The SEC rejected this contention and held that while the broker "undoubtedly occupied a fiduciary duty to his customers, this relationship could not justify any actions by him contrary to law." *Cady, Roberts & Co.*, 1961 WL 3743 , at *6. As the SEC explained, "even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary . . . . clients may not expect of a broker the benefits of his inside information at the expense of the public generally." *Id.* So too here, the plaintiffs may not claim they are entitled to benefit from the special relationship between William Chanoff and USSC officers or directors, insofar as the benefit they claim is contrary to established federal standards.

The court recognizes that defendant Scipione could have chosen not to speak with William Chanoff or could have disclosed the information to Mr. Chanoff and then disclosed it to the public,[1] both of which options would be consistent with the federal law. However, even if physical compliance with the state and federal standards were not physically impossible, the court finds that the selective duty to disclose implicit within the plaintiffs' state claims clearly undermines the congressional objectives underlying the federal scheme. *See Florida Lime & Avocado Growers*, 373 U.S. at 142-43; *Baker & Watts*, 876 F.2d at 1106. While Congress intended to encourage public dissemination of material information, such public disclosure is not furthered by recognizing a "unique relationship" or special duty to disclose to influential shareholders like William Chanoff.[2]

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[1] The court agrees with the defendants, however, that William Chanoff would not be entitled to take advantage of any information differential created in the time between these hypothetical disclosures.

[2] Moreover, even if such a duty could be recognized, the court would be hard pressed to find that the duty extended to William Chanoff's friends and relatives. Thus, even if the claims were not

Therefore, to the extent that plaintiffs' state claims are premised on a selective duty to disclose arising out of the alleged "unique relationship of trust and confidence between defendant Scipione . . . and William Chanoff," (*see, e.g.*, Compl. ¶¶ 111, 116, 121), the claims are preempted.

B. *Remaining State Claims: Damage and Standing*

Although what remains of the state claims may not be preempted, most of the claims fail on other grounds. Specifically, the court agrees with the defendants, that plaintiffs, with limited exception, have not alleged cognizable injury or damage that could be construed as directly or proximately caused by the alleged misconduct as required to sustain the common law causes of action.

In the plaintiffs' general allegation of damages, incorporated by reference in each of the counts, the plaintiffs allege the following injuries stemming from the defendants' conduct: (1) all plaintiffs declined to sell or hedge their USSC stock which has declined in value since January, 1992, (2) William Chanoff purchased 2000 additional shares of USSC stock at artificially inflated prices, (3) William Chanoff, Rachel Chanoff and Harriet Fingerote received margin calls as a result of declines in the stock's value, (4) William Chanoff, Rachel Chanoff and Harriet Fingerote incurred significant tax liabilities that could have been avoided had they known the truth and (5) William Chanoff suffered emotional distress and a decline in his health. (*See* Compl. ¶¶ 96-99.) With these claimed damages in mind, the court now turns to the specific counts.

1. *Fraud: Counts I & II*

To state an action for fraud, a plaintiff must allege that "(1) a false representation was made as a statement of fact; (2) the statement was untrue and known to be so by its maker; (3) the statement was made with the intent of inducing

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preempted, it is unlikely that the plaintiffs other than William Chanoff would be able to sustain claims based on statements made by defendant Scipione directly to William Chanoff.

reliance thereon; and (4) the other party relied on the statement to his detriment." *Billington v. Billington*, 220 Conn. 212, 217 (1991). It is settled, however, that to recover for fraud, as for all torts generally, a plaintiff must allege injury that is the direct and proximate result of the alleged misconduct. *See, e.g., Holmes v. Securities Investor Protection Corp.*, ___ U.S. ___, 112 S. Ct. 1311, 1317 (1992) (common law actions require direct relation between the injury asserted and the injurious conduct alleged); *Applied Data Processing Inc. v. Burroughs Corp.*, 394 F. Supp. 504, 510-11 (D. Conn. 1975) (Newman, J.); *Kilduff v. Adams, Inc.*, 219 Conn. 314, 323 (1991); *Morrell v. Wiley*, 119 Conn. 578, 582, 584 (1935). The Connecticut Supreme Court has explained that "those results are proximate which must be presumed to have been within the contemplation of the defendants as the probable consequence of his fraudulent representations." *Kilduff*, 219 Conn. at 323-24. *See also Holmes*, 112 S. Ct. at 1317 ("the notion of proximate cause reflects 'ideas of what justice demands, or of what is administratively possible and convenient.' " (citation omitted)).

Thus, as William Chanoff claims that he was induced to buy additional shares of USSC stock at artificially inflated prices because of the defendants' misconduct, he has alleged injury that may at least be found to be proximately related to the alleged fraud, and has therefore stated a claim to the extent that he seeks relief for such injury.[3]

The remaining claims made by William Chanoff and the other plaintiffs suffer a different fate. First, the claims for damages based on the plaintiffs' failure to sell or hedge their stock are too speculative to be actionable. "It is an established principle that a plaintiff cannot recover profits which might have been realized if he had not been deceived, unless there is evidence by which such profits can be estimated with reasonable certainty." *Morrell*, 119 Conn. at 584; *see also Pacelli Bros. Trans.*, 189 Conn. 410, 411 (1983). Along these

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[3] The court notes that any damages would have to be limited so as to avoid any double recovery under the Rule 10b-5 and the common law fraud claims.

lines, this circuit has recognized that the "case of a defrauded securities buyer, whose gain was speculative, is surely different from the case of a seller who does not receive the price for which he bargained. The distinction lies in the ability to determine damages with certainty." *Osofsky v. Zipf*, 645 F.2d 107, 112 (2d Cir. 1981); *appeal after remand*, 725 F.2d 1057 (2d Cir. 1984). Here, the claim for damages is further attenuated as plaintiffs allege a separate damages claim for shares, neither bought nor sold, but merely retained.

In addition, the defendants argue, somewhat compellingly, that the plaintiffs have not alleged cognizable loss because plaintiffs cannot claim the right to profit from what they allege was an unlawfully inflated stock value. In rebuttal, the plaintiffs argue that had the disclosures been timely made, in the early stages of the JIT program, the market would not have responded as drastically as it did when the disclosures were made in 1993, thereby characterizing their loss as the difference in the impact of the disclosures on the market, not lost profits. Yet this argument is merely a creative costume for the lost profits claim, which courts have clearly rejected.[4] Moreover, even if the court accepted plaintiffs' attempt to distinguish their claim, the claim would not be actionable as it is not subject to even reasonable estimation; rather, because, as the plaintiffs conceded at oral argument, there is not one precise point at which the defendants' duty to disclose information concerning the JIT program attached, and in light of the difficulty in quantifying the value of earlier disclosure, the actual calculation of such damages would be intractable at best.

Nor can it be said that the margin calls, also claimed as damages, were the direct result of the alleged fraud. The court simply cannot presume that such margin calls were " 'within

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[4] As the Fifth Circuit has stated, "if the [plaintiffs] had received this information and sold their stock before the public was made aware [of this information], such a profit would have resulted from insider trading in violation of the securities laws. It is too much to ask the court to recognize an injury based on a lost profit to which no one was lawfully entitled." *Crocker v. FDIC*, 826 F.2d 347, 351 n.6 (5th Cir. 1987); *cert. denied*, 485 U.S. 905 (1988).

the contemplation of the defendant[s] as the probable consequence of [their] fraudulent representations.' " *Applied Data Processing*, 394 F. Supp. at 509 (citation omitted). Rather, margining is an aggressive and high-risk investment strategy that is not only based on the prospects of a particular stock but on numerous factors, including the relative value of the stock compared to the stocks or assets against which it is margined. Indeed, were the court to extend liability to include recovery for margin calls, it would effectively shift the risks assumed by the margining investor to the corporate officers, and the court finds no basis for such arbitrary risk spreading.

Furthermore, even if it could be said that margining would be a foreseeable result of the alleged misconduct, the consequent margin calls are too remote or indirect an injury to be actionable. Typically, margin accounts are supported by a portfolio of assets; to the extent that a portfolio does contain other assets, those assets, in addition to the margined stock, would also have impact on the marginable asset base. Thus, while a decline in a margined asset might weaken the overall asset base, the impact of such a decline is a result of a combination of factors and seems well within the risk assumed by undertaking such an aggressive investment strategy. In short, the losses suffered as a result of the margin calls were directly related to the plaintiffs' investment strategy, and not the alleged fraud.

Plaintiffs William Chanoff, Rachel Chanoff and Harriet Fingerote further allege that they incurred significant tax liabilities which they could have avoided had they been privy to the undisclosed information. The defendants challenge the logic of this claim; yet even assuming, as the court must in the context of this motion to dismiss, that the plaintiffs did incur increased liability, the loss of tax benefits is not recoverable as damages. First, because tax benefits "accrue only if the tax deductions or credits the investment throws off are *combined* with income generated by the investor or taxes owed on such income . . . ," *Randall v. Loftsgaarden*, 478 U.S. 647, 658 (1986), such benefits cannot be deemed a

"direct product" of the security that would be recoverable as actual damages. *Id.* Furthermore, such a claim for damages is too speculative to be actionable; indeed, as the *Randall* Court noted, the "formidable difficulties in predicting the ultimate treatment of the investor's claimed tax benefits," *id.* at 665, render such claims unfeasible for the purpose of calculating damages.

Finally, William Chanoff claims damages for the emotional distress he suffered as a result of the alleged misconduct. Although Connecticut allows for recovery of emotional damages in fraud actions, such damages are only recoverable where they may be considered the "natural and proximate result of fraud." *Kilduff*, 219 Conn. at 324. Such a claim is untenable where, as here, the remaining claim is premised on a fraud-on-the-market theory of liability. In addition to the myriad problems of proof and certainty that would be created by recognizing a claim for emotional damages arising out of a public fraud as alleged herein, it is simply unreasonable to presume that an individual's emotional distress would be contemplated by the defendants who are alleged to have perpetrated that fraud.[5]

Therefore, the court finds that the plaintiffs have, for the most part, failed to allege actionable damages that could be found to be the direct and proximate result of the defendants' conduct. The fraud claims shall thus be dismissed except as to William Chanoff's claim for fraudulent inducement to buy additional USSC shares.

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[5] It is conceivable that William Chanoff would be able to state a claim for emotional injury stemming from the statements made directly to him by defendant Scipione, by alleging that defendant Scipione was aware of his personal, financial and physical condition, and therefore had reason to believe that her statements could have such emotional as well as physical impact. However, the court has previously found that any claims based on defendant Scipione's direct statements or a special duty to disclose to William Chanoff are preempted. Therefore, the claim for emotional damages can only be construed with respect to the remaining portion of the fraud claim which is based on the defendants' general duty to disclose to the public.

2. *Breach of Fiduciary Duty: Count III*

In Count III, plaintiffs allege that the defendants breached their fiduciary duties owed to the plaintiffs by trading on inside information without disclosing such information. The defendants argue that the plaintiffs lack standing to assert this claim because defendants owe no independent fiduciary duty to the plaintiffs, and the plaintiffs have failed to allege direct harm as a result of the alleged breach. The court agrees.

As discussed above, this claim is preempted to the extent that it is premised on a unique relationship of trust between defendant Scipione and William Chanoff and a resulting special duty to disclose to William Chanoff. Plaintiffs further allege, however, that the defendants breached their fiduciary duty to plaintiffs, as well as all shareholders, in failing to disclose the material information to the public and in taking advantage of and trading on their superior knowledge. This claim is flawed in two respects: First, similar to the discussion in the context of the fraud claim, plaintiffs have failed to allege direct harm or actionable damages flowing from the alleged breach.[6] Second, plaintiffs have failed to allege a duty directly owed to them, and therefore lack standing to assert this claim.

In Connecticut, as elsewhere, " '[a]n officer and director occupies a fiduciary relationship to the corporation and its stockholders.' " *Pacelli Bros. Trans.*, 189 Conn. at 407 (quoting *Katz Corp. v. T.H. Canty & Co.*, 168 Conn. 201, 207 (1975)). Generally, a corporate director's responsibility to the corporation and shareholders only extends to the corporate property actually under the director's control. *See Strong v. Rapide*, 213 U.S. 419, 431 (1909). Furthermore, these various duties are owed to the corporation directly, and only indirectly the corporation's shareholders. *See Treadway v. CARE Corp.*, 638 F.2d 357, 375 (2d Cir. 1980); *Yanow v. Teal Indus.*,

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[6] Indeed, insofar as the breach of the fiduciary duty is premised on the defendants' trading on inside information, it cannot be said that William Chanoff's purchase of additional shares at inflated prices, which is arguably a direct result of the alleged fraud, was caused by this alleged breach of fiduciary duty.

Inc., 178 Conn. 262, 281 (1979). Any harm caused to shareholders as a result of a breach of these duties is thus said to be derivative of the harm to the corporation. As a rule, however, individual shareholders lack standing to sue officers at law for damages based on such derivative injury. *Yanow*, 178 Conn. at 281.

The plaintiffs are correct though that under special circumstances a corporate officer may owe a duty to individual shareholders which would support a direct cause of action by such shareholders for breach of that duty. When, for example, a "plaintiff-shareholder sustains loss separate and distinct from that of the corporation, or from that of other shareholders, . . . [the plaintiff] has the right to seek redress in a personal capacity for the wrong done to him individually." *Yanow*, 178 Conn. at 282; *see also Strong*, 213 U.S. at 431.

Here, however, the plaintiffs fail to allege a duty owed distinctly to them. The plaintiffs claim that in trading on inside information without disclosing such information to the public, the defendant officers and directors breached their fiduciary duty to disclose owed to the shareholders individually. However, it "has been recognized that inside trading by a corporate fiduciary may be a violation of the common-law duty which he owes to the corporation," *Katz v. T.H. Canty and Co.*, 168 Conn. 201, 210 (1975), but not to individual shareholders. *See id.* (derivative action by shareholder for directors' breach of fiduciary duty). Indeed, the weight of common law authority has rejected the contention, central to the plaintiffs' claim, that a corporate officer, merely by virtue of status, occupies a position of trustee toward individual stockholders in the corporation. *See, e.g., Treadway*, 638 F.2d at 374, 375 (the majority rule is that directors do not owe a fiduciary duty directly to the shareholders); *Arrigoni v. Adorno*, 129 Conn. 673, 681 (1943) (a corporate officer "occupies a fiduciary relationship to the corporation and its stockholders, but he is not a trustee in the strict sense of the term."); *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659, 660 (Mass. 1933) ("directors are not the bailees, the factors,

agents, or trustees of such individual stockholders." (citation omitted)).

While a director may assume a direct fiduciary relationship to an individual shareholder by engaging in a personal transaction with the shareholder, *see Strong*, 213 U.S. at 431, no such duty is assumed where, as here, the alleged transactions all occurred on a public exchange, in which "the purchases and sales of stock . . . are commonly impersonal affairs." *Goodwin*, 186 N.E. at 660 (finding that corporate officers who bought shares in corporation on a stock exchange based on inside information had no direct fiduciary obligation to disclose such information to plaintiff shareholder who sold his shares on the exchange).[7] *See also In re Cady, Roberts & Co.*, 1961 WL 3743, at *5 (acknowledging rule that unless plaintiffs have bought from or sold to insider, they lack privity to recover under a private cause of action). *Strong* is illustrative: in that case, the Supreme Court explained that while a shareholder could not bring a direct action for breach of fiduciary duty against a director for general failure to disclose information based on the "bare relationship between director and shareholder," a shareholder could bring such an action where the director purchased shares from the shareholder without disclosing facts which affected the value of the shares. *Strong*, 213 U.S. at 429.[8]

Interestingly, although the federal securities laws concerning insider trading were enacted, at least in part, to fill gaps left by the common law rules, the federal laws echo these same common law principles.[9] In the context of Rule

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[7] Acknowledging that this distinction is governed by rules of practice, and that "[l]aw in its sanctions is not coextensive with morality," the *Goodwin* court explained that "fiduciary obligations of directors ought not be made so onerous that [individuals] . . . will be deterred from accepting such office." *Goodwin*, 186 N.E. at 660.

[8] The court notes that the *Strong* case originated in the Philippines, then a territory of the United States, and thus relied on federal civil law, not state common law.

[9] In *Dirks v. SEC*, the Supreme Court noted that the federal "duty that insiders owe to the corporation's shareholders not to trade on inside information differs from the common law duty that officers and directors

10b-5 actions for unlawful insider trading, for example, this circuit has explained that "any duty of disclosure is owed only to those investors trading contemporaneously with the insider; non-contemporaneous traders do not require the protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information." *Wilson v. Comtech Telecommun. Corp.*, 648 F.2d 88, 94-95 (2d Cir. 1981) (finding no standing to assert unlawful insider trading under Rule 10b-5). Similarly, in creating a private cause of action for insider trading, section 20(a) of the 1934 Securities Exchange Act expressly limited standing to contemporaneous investors in securities of the same class. 15 U.S.C. § 78t-1(a). The imposition of this "contemporaneous investor" standing requirement in the federal securities laws reflects the basic common law principle, applicable here, that only those clearly ascertainable individuals who stand to be exploited by the insider trading—for example, by personally trading with the insider or, in the context of the federal law, by trading on the same market with the insider—can be said to have individual interests that are directly implicated by the insider trading for which they may seek direct redress.[10]

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also have to the corporation itself not to mismanage corporate assets, of which confidential information is one." *Dirks*, 463 U.S. 646, 652 (1983). The court further noted that a primary purpose of the federal act "was to eliminate the idea that personal advantage was a normal emolument of corporate office." *Id.* at 653 n.10.

[10] It has been suggested that the issue of a director's common law liability for trading on inside information "has been largely mooted by the advent of a federal cause of action under § 10b of the 1934 Act . . . ." *Treadway*, 638 F.2d at 375 n.35. The court notes, however, that even under the federal standard, which arguably allows broader relief to individual shareholders, the plaintiffs do not state a viable claim. Because plaintiffs David Chanoff, Rachel Chanoff and Harriet Fingerote did not trade in their USSC stock, the court could not find that they were owed an individual duty that would support a direct claim under federal law. Furthermore, although William Chanoff did purchase USSC shares, he did so on October 9, 1992, more than a month from the most temporally proximate trade undertaken by any one of the defendants, and therefore he could not be deemed to have been a "contemporaneous investor" for the purpose of stating a federal claim. (*See* Compl. ¶¶ 38, 69.) (alleging

Yet here because plaintiffs did not engage in any face-to-face transactions with the defendant officers or directors, they fail to allege any basis for this direct claim for breach of fiduciary duty. Plaintiffs fail as well to claim actionable damages. Therefore, even if the defendants breached fiduciary duties owed to the corporation and indirectly to shareholders, plaintiffs lack standing to bring a direct action for such breach. Thus, this claim shall be dismissed as to all plaintiffs.

3. *Negligence: Counts IV & V*

Similarly, plaintiffs' negligence claims fail not only for failure to allege proximate injury but also for lack of standing. Relying on the Restatement (Second) of Torts § 552, plaintiffs contend that a claim for negligent misrepresentation may flow from a public duty to disclose where, as here, plaintiffs are within the class of persons for whose benefit such disclosure was to be made. The court, however, declines to impose such indeterminate liability.

Connecticut follows the common law elements of negligent misrepresentation as set forth in the Restatement (Second) of Torts § 552. To state such a claim, the plaintiffs must allege that an individual in the course of his business or employment supplied false information for the guidance of others in their business transactions, that the individual failed to exercise reasonable care in obtaining or communicating the information, and that the plaintiffs suffered pecuniary loss as a result of their justifiable reliance on the information. *Mason v. Burkett*, 756 F. Supp. 679, 681 (D. Conn. 1991) (citing Restatement (Second) Torts, § 552). The Restatement further provides that "the liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them." Restatement (Second) § 552(3).

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trading activity by the defendants between January 20, 1992 and March 17, 1992, and between November 10, 1992 and December 16, 1992). *Cf. Wilson*, 648 F.2d at 94-95 (trader who purchased stock one month after defendants' sales lacked standing to sue for unlawful trading under Rule 10b-5).

The remaining portion of this claim, that which the court has found not preempted, is based on negligence stemming from defendants' public disclosures. However, where, as in this context, "a corporation does not and cannot know the identity of the recipients of its disclosures at the time those disclosures are made, liability under Section 552 does not obtain." *In re Westinghouse Sec. Litig.*, 832 F. Supp. 948, 988 (W.D. Pa. 1993). Indeed, to recognize plaintiffs' claim and the potential liability " 'in an indeterminate amount for an indeterminate time to an indeterminate class' would be contrary to the language and intent of Section 552." (quoting *Ultramares Corp. v. Touche*, 255 N.Y. 170, 189, 174 N.E. 441, 448 (1931) (Cardozo, J.)). Therefore, this claim shall be dismissed as to all plaintiffs.

4. *Conn. Gen. Stat. § 36-472*

Defendants contend that the § 36-472 claim fails because there is no private right of action under the statute, the claims lack sufficient nexus to Connecticut as required under the act and even if a private right of action existed, the plaintiffs fail to meet the purchaser/seller requirement.

The plaintiffs concede that the purchaser/seller requirement applies to the state claim and thus limit their claim to the 2000 shares bought by William Chanoff. However, because the court agrees that there is no private right of action under the statute, the court need not address the other arguments raised and this claim shall be diminished in its entirety.

Conn. Gen. Stat. § 36-472 directly tracks the language of Rule 10b-s, and does not expressly provide for a private cause of action although the related § 36-498 does. There is a split in this district, however, as to whether because there is a private right of action under Rule 10b-5, it is reasonable to assume that a similar right may be implied under § 36-472. *Compare Weisman v. Oliver Rose Sec. Inc.*, B-85-126 (1987) (Burns, J.) (attached as Pl. Ex. 7 at 61) (finding implied right of action); with *Heineman v. Kemp*, B-87-615 (1988) (Daly, J.) (attached as Pl. Ex. 5, at 9) ("Plaintiffs admit that there is no private right of action under § 36-472.") *and Zuccarelli v.*

North American Holding Corp., 1991 Conn. Super. 642, (attached as Pl. Ex. 8) ("the court agrees that § 36-472 does not create a private cause of action."). *See also Clute v. Davenport*, 584 F. Supp. 1562, 1574 (D. Conn. 1984) (declining to reach issue, but noting that the court may refer to federal statutes as well as the Uniform Securities Act to resolve the question).

In the interests of consistency, the court chooses to follow the more recent, albeit scant, precedent from this District and the Connecticut Superior Court. In light of this precedent, and until such time as the Connecticut Supreme Court or legislature dictates to the contrary, the court declines to imply a private cause of action under § 36-472, and therefore, Count VIII shall be dismissed as to all plaintiffs.

II. *Federal Claims*

The plaintiffs' complaint alleges the following federal claims: in Count VI, plaintiffs allege a violation of Section 10b of the 1934 Federal Securities Act, 15 U.S.C. § 78j(b) and Rule 10b-5, promulgated thereunder, and in Count VII, plaintiffs allege violations of the Racketeering Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1961 *et seq* against the individual defendants.

A. *Rule 10b-5 Claims*

Defendants argue that because the crux of the plaintiffs' claims are for fraudulent inducement to *retain* shares, they are merely holders of shares, not purchasers or sellers, and therefore are not entitled to a private cause of action under Rule 10b-5. The court agrees.

To state a claim under Section 10(b) and Rule 10b-5, plaintiffs must allege that, " 'in connection with the purchase or sale of securities, the defendant[s], acting with scienter, made a false material representation or omitted to disclose material information and that the plaintiff[s'] reliance on the defendant[s'] actions caused [them] injury.' " *Ferber v. Travelers*, 802 F. Supp. 698, 705 (D. Conn. 1992) (Nevas, J.) (citation omitted). The Supreme Court has held, however, that Rule

10b-5 claims are limited to individuals who either bought or sold shares during the time in which the market was allegedly defrauded. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737-38 (1975) (shareholders who have neither bought nor sold shares have no standing to bring Rule 10b-5 private cause of action).

Plaintiffs apparently concede that the Rule 10b-5 claims cannot be based on shares that were neither purchased nor sold as they do not respond to this argument in their response. In light of this, the federal claims for fraudulent inducement to retain shares shall be dismissed. William Chanoff's Rule 10b-5 claim based on the 2000 additional shares he bought during the relevant time period does not share this defect and thus shall not be dismissed.

B. *Rico Claims*

The defendants further argue that because the plaintiffs lack standing to allege a Rule 10b-5 claim, they are similarly barred from bringing a RICO action based on a 10b-5 predicate offense. While the court agrees with the defendants, this argument does not alone defeat the RICO claim. Rather, the court finds that the RICO claim must be dismissed on additional grounds.

18 U.S.C. § 1964 creates a private right of action for "[a]ny person injured in his business or property by reason of a violation" of the Rico statute, as described in 18 U.S.C. § 1962. To state a claim for such a violation, the complaint "must allege (1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity." *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 651 F. Supp. 877, 882 (D. Conn. 1986) ("*Andreo I*") (citing *Sedima*, 473 U.S. at 496). To establish a "pattern of racketeering activity" under RICO, the complaint must allege the commission of "at least two acts of racketeering activity" by each defendant. 18 U.S.C. § 1961(5); *Celpaco, Inc. v. MD Papierfabriken*, 686 F. Supp. 983, 992 (D. Conn. 1988). RICO defines an act of "racketeering activity" as (1) the commission of certain

felonies "chargeable under state law" and specifically enumerated by the statute; (2) certain enumerated acts indictable under Title 18; (3) certain enumerated acts indictable under Title 29 of the United States Code; (4) "any offense involving fraud connected with a case under title 11 of the United States Code . . . " ; or (5) any violation of the federal narcotics laws. 18 U.S.C. S 1961(1). The acts of racketeering activity, moreover, are referred to as the "predicate" acts or offenses in a RICO action. *See, e.g., Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 49 (2d Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988); *overruled on other grounds, United States v. Indelicato*, 865 F.2d 1370 (2d Cir. 1989). The Supreme Court has explained that to meet the "pattern" requirement, "the predicate acts must be related and must be part of a continuous criminal endeavor." *International Data Bank v. Zepkin*, 812 F.2d 149, 154 (4th Cir. 1987) (*citing Sedima v. Imrex Co., Inc.*, 473 U.S. 479 (1985)).

Applying these rules and based on the court's discussion of William Chanoff's state and federal fraud claims, the court finds that upon the generous reading of the complaint required in this context, William Chanoff has stated a RICO claim to the extent that he alleges he was fraudulently induced to purchase additional shares of USSC at inflated prices.[11] Such is not the case for the other plaintiffs, who, the

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[11] This is not to say that William Chanoff's claims for damages are all sustainable as injury to business or property as required under RICO. For example, it seems clear that damages for emotional distress, claimed by William Chanoff, are not recoverable as damages to business or property under RICO. *Accord Zimmerman v. HBO Affiliate Group*, 834 F.2d 1163, 1169 (3d Cir. 1987) (mental distress is not actionable under RICO); *Manson*, 823 F. Supp. at 80-81 (murder threat does not cause type of injury protected under RICO).

The court further notes that while it might seem appropriate to impose more exacting pleading requirements on RICO claims, which allow plaintiffs to recover treble damages from defendants for criminal conduct established under civil standards of proof, the court recognizes that "[c]omplaints that RICO may effectively federalize common law fraud and erode recent restricting on claims for securities fraud are better addressed to Congress than to courts." *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 21 (2d Cir. 1983); *cert. denied*, 465 U.S. 1025 (1984).

court has already found, fail to state viable state or federal fraud claims as they were neither purchasers nor sellers of stock and have not pled actionable damages.

First, the court agrees with the defendants that the other plaintiffs fail to state a valid Rule 10b-5 predicate claim. Although plaintiffs may be correct in contending that there is no general purchaser-seller standing requirement under RICO, courts have held that where the plaintiff pleads a predicate 10b-5 violation, the 10b-5 standing requirement still applies. *Zepkin*, 812 F.2d at 152 ("where the RICO plaintiff pleads a 10b-5 predicate offense, standing would be limited to actual purchaser or seller of securities.") *Accord Par Pharmaceutical Inc. Sec. Litig.*, 733 F. Supp. 668, 683 (S.D.N.Y. 1990) (RICO limited to fraudulent acts in the actual sales transaction). Furthermore, the plain language of RICO indicates that it is directed at "fraud in the sale of securities . . . ." 18 U.S.C. § 1961(1)(D). While there seems to be a split in the courts on this purchaser-seller issue, there is at least consensus with respect to the general, and logical, rule that when a plaintiff fails to state a viable securities fraud claim, that claim may not serve as a valid RICO predicate. *See e.g.*, *Somerville v. Major Exploration*, 576 F. Supp. 902, 913-914 (S.D.N.Y. 1983); *Mauriber v. Shearson/American Express*, 546 F. Supp. 391, 397 (S.D.N.Y. 1982). *See also Holmes*, 112 S. Ct. at 1321 (declining to resolve conflict on issue, but suggesting that most cases can be resolved on basis of proximate cause).

The defendants' motion to dismiss the RICO claim focuses on the plaintiffs' failure to state a Rule 10b-5 claim. Yet that the 10b-5 claim is not a viable predicate does not alone foreclose the RICO claim because plaintiffs allege additional predicate acts such as mail, wire and common law fraud.[12]

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[12] To prove mail or wire fraud, the private litigant must establish 1) a scheme or artifice to defraud to obtain money or property by means of false and fraudulent representations, 2) the use of the mails or wire in furtherance of executing such scheme and 3) the defendant connected with the scheme used or caused the use of the mails or wires. *See, e.g.*, *Phoenix Home Life Ins. Co. v. Greenwich Acupuncture Ctr.*, 1993 WL

However, as discussed above, plaintiffs fail to allege damages that could be found proximately related to the conduct, and therefore, they fail to allege individual injury to their business or property sufficient to sustain the RICO claim. *See Leach v. FDIC*, 860 F.2d 1266, 1273 (5th Cir. 1988), *cert. denied*, 491 U.S. 905 (1989) (finding that shareholders failed to state viable RICO claim because they did not allege injury to property that was distinct from injury suffered by corporation, and therefore had not alleged individual injury required under RICO); *cf. Ceribelli v. Elghanayan*, 990 F.2d 62, 62-63 (2d Cir. 1990) (so long as plaintiffs suffered injury directly, they had standing to bring RICO claim even if corporation suffered identical injury for which it had similar right to recovery).

In *Manson v. Stacescu*, 823 F. Supp. 76, 79 (D. Conn. 1993) (Eginton, J.), *aff'd*, ___ F.3d ___, 1993 WL 513376 (2d Cir. 1993), the court explained that, as a rule, shareholders are prohibited from bringing individual suits under RICO unless they can show direct harm in addition to the economic impact on the company. For example, the court noted that "minority shareholders have been granted standing under RICO when a majority shareholder violated a fiduciary duty owed directly to plaintiff, in addition to committing fraud on the company which caused plaintiff's stock to depreciate in value (citations omitted)." *Manson*, 823 F. Supp. at 80; *see Leach*, 860 F.2d at 1273 n.14 (property must be defined according to state law).

In contrast, here the plaintiffs do not allege breach of a duty owed directly to them, and in the absence of such, the plaintiffs' claims for depreciation in stock value are merely derivative in nature and thus fail to confer standing under RICO. *Accord Crocker v. FDIC*, 826 F.2d 347, 351 (5th Cir. 1987) (holders of stock who alleged diminution in stock value or lost profit opportunity failed to plead injury sufficient to state valid RICO claim); *cf. Ceribelli*, 990 F.2d at 63 (shareholder may bring individual RICO claim only for nonderivative injury).

298967, *2-3 (D. Conn. 1993); *Micro-Medical Indus., Inc. v. Hatton*, 607 F. Supp. 931, 936 (D.P.R. 1985).

Nor do the other claims of injury provide a basis to sustain this claim: Plaintiffs claim damages for margin calls and increased tax liability; yet even if the court could find that any or all of such damages could be construed as damage to business or property as required under the RICO statute, as discussed above, the alleged damages cannot be said to be proximately related to the claimed predicate acts of fraud. *See Holmes*, 112 S. Ct. at 1317 (1992) (explaining that injury must be proximate result of alleged harm). Thus, plaintiffs fail to state a RICO claim based on the alleged misconduct, *see Manson*, 823 F. Supp. at 78 (RICO standing limited to plaintiffs who allege injuries proximately caused by the predicate acts), and the claim shall be dismissed as to plaintiffs David Chanoff, Rachel Chanoff and Harriet Fingerote.

CONCLUSION

Based on the foregoing, the defendants' motion to dismiss [doc. #18] is GRANTED in part and DENIED in part. The motion is granted with respect to Counts III, IV, V, VIII and David Chanoff's, Rachel Chanoff's and Harriet Fingerote's claims contained in Counts I, II, VI and VII. The motion is denied with respect to William Chanoff's claims contained in Counts I, II, VI and VII only insofar as he claims damages flowing from his purchase of 2000 shares of USSC stock. However, because the surviving claims are substantially similar to those raised in the related pending class action litigation, these claims shall be consolidated with such litigation. (*See USSC Sec. Litig.*, 3:92CV00374 (AHN).)

SO ORDERED this 4th day of January, 1994 at Bridgeport, Connecticut.

ALAN H. NEVAS

Alan H. Nevas
United States District Judge

APPENDIX D

UNITED STATES DISTRICT COURT

DISTRICT OF CONNECTICUT

Filed March 15, 1994
Civil No. 3:93-cv-1522 (AHN)

WILLIAM CHANOFF, et al

—v.—

UNITED STATES SURGICAL CORP., et al

JUDGMENT

This cause came on for consideration of the plaintiffs' motion for entry of judgment and Rule 54(b) certification, before the Honorable Alan H. Nevas, United States District Judge, and

The Court having considered the motion and all the papers submitted in connection therewith filed it Order Directing Entry of Final Judgment granted the plaintiffs' motion pursuant to rule 54(b) and further directed the Clerk to enter final judgment in favor of the defendants as to all claims alleged by plaintiffs David Chanoff, Rachel Chanoff and Harriet Fingerote, as well as the claims alleged by plaintiff William Chanoff in Counts III, IV, V and VIII of the plaintiffs' complaint,

It is therefore ORDERED and ADJUDGED that final judgment be and hereby is entered in favor of the defendants as to

all claims alleged by plaintiffs David Chanoff, Rachel Chanoff and Harriet Fingerote, as well as the claims alleged by plaintiff William Chanoff in Counts III, IV, V, and VIII of the plaintiffs' complaint, in accordance with the Court's order, pursuant to Rule 54(b).

Dated at Bridgeport, Connecticut this 15th day of March, 1993.

KEVIN F. ROWE, Clerk

By CAROL E. CANNADY
Carol E. Cannady
Deputy in Charge

APPENDIX E

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF CONNECTICUT

Filed July 30, 1993
Civil Action No. 3:93 CV1522 (AHN)

WILLIAM CHANOFF, DAVID CHANOFF, RACHEL CHANOFF and HARRIET FINGEROTE,

Plaintiffs,

—vs.—

UNITED STATES SURGICAL CORPORATION, LEON HIRSCH, TURI JOSEFSEN, BRUCE C. LUSTMAN and MARIANNE SCIPIONE,

Defendants.

COMPLAINT

JULY TRIAL DEMANDED

Plaintiffs William Chanoff, David Chanoff, Rachel Chanoff and Harriet Fingerote, by their attorneys Orrick, Herrington & Sutcliffe and Pullman & Comley, allege, upon personal knowledge as to themselves, their own acts, the discussions they participated in and the contents of the documents they reviewed, and upon information and belief, based upon, *inter alia*, public filings, press releases, other publicly-available documents and the investigation of their attorneys as to all other matters, as follows:

NATURE OF THE CASE

1. Plaintiffs are long-time shareholders of United States Surgical Corporation ("USSC or "the Company") who have seen the value of their stock decline by over $40 million and have brought this action to recover damages for their losses, which were suffered as a result of fraud and other violations of state and federal law committed by USSC and four of its directors and officers: defendants Leon Hirsch, Turi Josefsen, Bruce C. Lustman and Marianne Scipione (collectively the "Individual Defendants"). From at least January, 1992, through April 14, 1993, while the Individual Defendants sold over 1.7 million shares of their own USSC stock and reaped proceeds of over $155 million, they made and caused USSC to make false and misleading positive statements of material fact concerning the Company, and omitted and concealed adverse material information concerning the Company which they had an affirmative duty to disclose to plaintiffs herein and which was necessary to make the statements made not false and misleading. Defendants' misconduct included misrepresentations, misleading statements and omissions made directly to plaintiff William Chanoff, with whom they had engendered a relationship of trust and confidence, as well as in numerous public statements and documents. Defendants' actions were intended to and did cause plaintiffs to refrain from selling or hedging any of their USSC stock, which they would have done had they known the truth, and also caused William Chanoff to purchase additional shares, which he would not have done had he known the truth. When truthful information concerning the Company finally reached the market, the price of USSC's common stock fell sharply—by more than 30% in a single day of trading in April, 1993—and has never recovered. Moreover, a substantial portion of plaintiffs' stock was liquidated at low prices to satisfy margin calls, damaging them further.

PARTIES

2. Plaintiff William Chanoff is a resident of the Commonwealth of Pennsylvania and has been a shareholder of USSC since approximately 1967. From 1967 through 1976, William Chanoff served as a member of the Company's Board of Directors. As of January 1, 1992, William Chanoff was the beneficial owner of 371,436 shares of USSC's common stock. William Chanoff is 82 years old.

3. Plaintiff David Chanoff, a son of William Chanoff, is a resident of the Commonwealth of Massachusetts and has been a shareholder of USSC since approximately 1971. As of January 1, 1992, David Chanoff was the beneficial owner of 8900 shares of USSC's common stock.

4. Plaintiff Rachel Chanoff, a daughter of William Chanoff, is a resident of the State of New York and has been a shareholder of USSC since approximately 1971. As of January 1, 1992, Rachel Chanoff was the beneficial owner of 3436 shares of USSC's common stock.

5. Plaintiff Harriet Fingerote, a close personal friend of William Chanoff, is a resident of the Commonwealth of Pennsylvania and has been a shareholder of USSC since approximately 1971. As of January 1, 1992, Harriet Fingerote was the beneficial owner of 20,000 shares of USSC common stock. Harriet Fingerote is 65 years old.

6. Defendant USSC is a Delaware corporation with its principal place of business in Norwalk, Connecticut. USSC is in the business of manufacturing and marketing mechanical products for the wound closures market, including surgical stapling instruments, disposable surgical clip appliers and presterilized disposable loading units for use with the stapling instruments. Since 1987, USSC has also manufactured and marketed products designed for use during laparoscopic surgery, and in 1991 the Company introduced a line of sutures. At all times relevant to this action the common stock

of USSC was actively traded on the New York Stock Exchange ("NYSE").

7. Defendant Leon Hirsch is a resident of the State of Connecticut. At all times relevant to this action, defendant Hirsch was Chairman of the Board of Directors of USSC, as well as the Company's President and Chief Executive Officer. As of January 31, 1992, defendant Hirsch was the beneficial owner of 5,977,370 shares or 10.51% of USSC's outstanding common stock. Hirsch was and is the Company's top executive officer and chief public spokesman, and has appeared at numerous conferences and meetings with analysts to discuss USSC. Hirsch signed the letters to shareholders contained in USSC's annual and quarterly reports, reviewed and signed various reports filed by USSC with the Securities and Exchange Commission ("SEC"), and was ultimately responsible for reviewing and ensuring the accuracy and completeness of all statements and representations made about USSC by any of its officers and directors. During 1992 alone, Hirsch received $1,694,557 in salary and bonuses from USSC, $542,000 in long term incentive payments, $1,231,647 in "other compensation," and realized $58,475,821 on the exercise of USSC stock options.

8. Defendant Turi Josefsen, the wife of defendant Hirsch, is a resident of the State of Connecticut. At all times relevant to this action, defendant Josefsen was a member of the Board of Directors of USSC, as well as the Company's Executive Vice President and, since January 1, 1992, the President and Chief Executive Officer of Auto Sutures Companies (the division of USSC engaged in manufacturing and marketing surgical staplers and laparoscopic instruments). As of January 31, 1992, defendant Josefsen was the beneficial owner of 1,551,154 shares or 2.86% of USSC's common stock. Josefsen was chiefly responsible for the sales, distribution and marketing of USSC's principal product lines and oversaw its internal sales force. During 1992, Josefsen received $964,195 in salary and bonuses from USSC, $241,000 in long term

incentive payments, $66,213 in "other compensation," and realized $25,549,246 on the exercise of USSC stock options.

9. Defendant Bruce C. Lustman is a resident of the State of Connecticut. At all times relevant to this action, defendant Lustman was a member of the Board of Directors of USSC, as well as the Company's Chief Financial Officer, Executive Vice President and, since January 1, 1992, its Chief Operating Officer. As of January 31, 1992, Lustman was the beneficial owner of 1,146,000 shares or 2.12% of USSC's common stock. Lustman was responsible for overseeing the Company's finances and operations and reviewing and ensuring the accuracy of all statements disseminated by the Company concerning its finances and operations. During 1992, Lustman received $1,026,460 in salary and bonuses from USSC, $241,400 in long term incentive payments, and realized $21,474,725 on the exercise of USSC stock options.

10. Defendant Marianne Scipione is a resident of the State of Connecticut. At all times relevant to this action, defendant Scipione was USSC's Vice President, Corporate Communications and, since May 13, 1992, a member of its Board of Directors. As of January 31, 1992, Scipione was the beneficial owner of 180,834 shares of USSC common stock. Scipione was responsible for, among other things, USSC's communications with investors, both directly and through analysts and the press, which communications she made on behalf of, and with the authorization of, USSC and its senior management, including defendants Hirsch, Josefsen and Lustman. From January 1, 1992 through April 14, 1993, Scipione had frequent direct contact with William Chanoff, by telephone and by mail, concerning USSC's business and prospects.

JURISDICTION AND VENUE

11. This Court has subject-matter jurisdiction over this action pursuant to 28 U.S.C. § 1331, as this action arises under, *inter alia*, the laws of the United States, and pursuant to 28 U.S.C. § 1332, as this action is between citizens of different States and the matter in controversy exceeds the sum or value of $50,000, exclusive of interest and costs.

12. Venue is proper in this District pursuant to 28 U.S.C. § 1391, as all defendants reside in this District and a substantial part of the events and omissions giving rise to plaintiffs' claims occurred in this District.

SUBSTANTIVE ALLEGATIONS

William Chanoff's Close Relationship with USSC

13. From 1967 through 1976, when he retired to pursue other business interests, William Chanoff served on USSC's Board of Directors and observed and contributed to the Company's emergence as a world leader in the manufacturing and marketing of surgical products.

14. USSC's success, growth, and favorable prospects for future growth and profitability have been largely attributable, for the past fifteen years or more, to its well-trained and well-managed sales force. The sales force has marketed the Company's products directly to hospitals, clinics, surgeons and other customers throughout the United States and in many foreign countries. USSC's salespersons have been well-positioned both to cater to the individual needs of these customers and to train them in how to use the Company's products.

15. The Company has frequently recognized, and publicly emphasized, the importance of its sales force to USSC's success, as did analysts following its stock. On May 3, 1991, a cover story in USA Today concerning USSC's phenomenal growth stated, "Much of the credit for [the Company's] fast

growth goes to U.S. Surgical's salespeople. Though there's not a former doctor among them, they have earned a reputation for being some of the best-trained in the medical equipment field. Some stock analysts call them the Green Beret of sales." Similarly, in an article entitled, "U.S. Surgical's Sales Team Seen as Tops in its Field," published in Investor's Daily on August 1, 1991, the Vice President of USSC's domestic sales force, Judith Stant, was quoted as saying, "Without being able to provide that training to our customers, we only have half our product." In the same article, Hambrecht & Quist analyst Kurt Kroger referred to USSC's sales force as "the Green Berets of surgical selling," and stated that the Company had, "bar none, the most powerful, best established surgical sales force." And Robinson-Humphrey analyst John Runnigen remarked, "U.S. Surgical's got the top of the field."

16. For the past fifteen years or more, William Chanoff has had tremendous confidence in USSC's sales force and its abilities, which, he believed, would enable the Company to continue as a leader in the surgical supply field and dominate the newer sutures and laparoscopy markets. It was in large part due to his confidence in the present and future abilities of the sales force, together with his high opinion of the Company's research and development capabilities and the strength and vision of its management team, that he held his USSC shares for long-term appreciation and security and advised the other plaintiffs to do the same.

17. In the years following his resignation from USSC's Board of Directors, William Chanoff remained in close contact with the Company and made every reasonable effort to follow its fortunes carefully. He obtained and read USSC's annual and quarterly reports and other documents furnished to shareholders, as well as analysts' reports, articles published in newspapers such as the New York Times and the Wall Street Journal, and other materials concerning the Company.

18. In addition, William Chanoff communicated directly—and with increasing frequency in 1992 and early 1993—with

defendant Scipione, both by letter and by telephone, concerning various matters affecting the prospects of USSC and the value of its stock. For example, when analysts published projections concerning USSC, William Chanoff typically inquired of Scipione whether the Company was comfortable with the figures in question. Similarly, when there was sudden movement in USSC's stock price, William Chanoff typically asked Scipione whether the Company was aware of any reason for the movement. During almost every conversation he held with Scipione, William Chanoff inquired generally as to the Company's products and future prospects, and asked in particular about the Company's sales force. William Chanoff believed and relied on Scipione's positive responses to these questions, as well as the Company's generally optimistic SEC filings, reports, press releases and other public statements, which contributed to his confidence in USSC's management team, sales force and prospects, and in the wisdom of retaining his USSC stock for long-term appreciation and security without selling or hedging.

19. The communications between William Chanoff and defendant Scipione were conducted on a first-name basis and were sufficiently frequent, detailed and apparently open so as to engender great trust and confidence by William Chanoff in Scipione and those on behalf of which and whom she spoke. Scipione gave every indication that she took William Chanoff's questions and comments seriously and responded to his inquiries promptly, courteously, and at length, with every appearance (at the time) of candor. William Chanoff always spoke freely, fully and honestly with Scipione, came to expect and rely on Scipione to do the same with him, and reasonably believed that she understood his particular concern with the Company's sales force and that she would advise him of any developments that could cause him to reconsider his confidence in the ability of the sales force to maintain and increase USSC's dominant position in its field.

20. William Chanoff customarily advised the other plaintiffs herein as to whether to purchase, hold or sell USSC stock, and the other plaintiffs, based on their close personal relationships with William Chanoff, and on his knowledge of the Company's affairs and prospects resulting from his review of its public statements and other publicly-available information and from his relationship of trust and confidence with the Company, reasonably relied on and followed the advice of William Chanoff. At all times relevant to this action, William Chanoff advised the other plaintiffs to retain their USSC stock without selling or hedging.

Developments During 1992 and Early 1993

21. USSC's historical system of direct distribution to domestic customers, using its in-house sales force, required those customers to stockpile and manage significant inventories of USSC products. From the customer's point of view, there were certain disadvantages to this system, including the costs of maintaining, storing and managing inventory, and the risks of spoilage, shrinkage and obsolescence in connection with the inventoried supplies.

22. USSC faced significant competition in the surgical supply field from other manufacturers of similar goods, including, most significantly, the Ethicon division of Johnson & Johnson. Ethicon's products were priced below USSC's by 10 to 15%. Moreover, unlike USSC, Ethicon utilized a third-party distribution system, whereby the manufacturer sold its goods to regional or local distributors, which maintained sizable inventories and resold to end users such as surgeons and hospitals, making frequent deliveries on short notice as needed. The third-party distribution system was attractive to many end users, as it relieved them of the high costs and risks associated with holding and handling large inventories of surgical supplies. Thus, Ethicon and other competitors utilizing such systems enjoyed certain advantages over USSC in mar-

keting their products. In addition, distributors handling only competitors' products, and not handling USSC's products, had an incentive to and did tout those competitors' products to the disadvantage of USSC.

23. Both product prices and inventory expenses became increasingly significant in the early 1990s, as public attention focused on spiraling health-care costs. Surgeons and hospitals began to look for new ways to control their own costs and keep their charges to patients as low as possible. For these reasons, among others, USSC faced increasingly fierce competition in the early 1990s.

24. By early 1992, defendants Hirsch, Josefsen and Lustman recognized that the fierce competition that USSC was facing threatened its dominant position in the surgical supply field and called into question its ability to sustain its growth in the newer laparoscopy and sutures markets. In addition, they recognized that, in order to guard against the worst potential effects of the heightened competition facing the Company, they would be required to address the needs of its customers to reduce the high costs and risks associated with holding and handling large inventories of supplies. Consequently, these defendants caused USSC to develop and implement a distributor program for marketing its products domestically, known as the Just-in-Time ("JIT") program. Under the JIT program, instead of relying on its highly trained and effective internal sales force, USSC turned to non-employee, third-party distributors to market its products to end users such as surgeons and hospitals.

25. The JIT program was expected to have, and did have, certain material adverse effects on the Company's financial results and prospects, both short-term and long-term, in that, among other things:

(a) Under the JIT program, distributors were provided with sizable inventories of USSC products, thus permitting them to respond quickly to demands from end users, while the end

users themselves were expected and encouraged to allow their own inventories to fall to minimal levels before beginning to reorder from the distributors. Thus, the switch to the JIT program was expected to and did create an initial, temporary surge in the Company's sales figures and profits as the distributors purchased their initial inventories, followed by a slump in sales and profits as the end users allowed their own inventories to deplete before beginning to reorder from the distributors.

(b) Under the JIT program, USSC was required to sell its products to distributors at discounts of up to 15% off of the prices historically charged to end users purchasing directly from the Company. Thus, the switch to the JIT program would not only distort unit sales temporarily, as explained above, but was expected to and did adversely affect USSC's profit margins and revenues on a long-term basis.

(c) Under the JIT program, although some of USSC's own employees would continue to participate in educational and training programs for customers, they would no longer interact directly with hospitals and surgeons on sales calls or take product orders, which had historically enabled them to become familiar with and to cater to the individualized needs of the Company's customers. Thus, the switch to the JIT program was expected to and did result in additional lost sales over the long term.

26. USSC began to implement the JIT program in the first quarter of 1992. By the fourth quarter of 1992, the program was well under way and being used heavily by USSC. During the first quarter of 1993, USSC further accelerated the program. USSC expected the temporary surge in sales attendant upon the distributors' purchases of their initial inventories to occur, and it did occur, by the fourth quarter of 1992 and to an even greater extent in the first quarter of 1993.

27. Each of the Individual Defendants was aware of the increasingly fierce competition faced by USSC and the Com-

pany's decision to respond by, among other things, developing and implementing the JIT program. Each of the Individual Defendants was also familiar with the expected adverse effects of the JIT program on the Company's financial performance. Defendant Josefsen, who was responsible for the sales, distribution and marketing of USSC's principal product lines, was also responsible for creating and implementing the program, with the knowledge and encouragement of her husband, USSC's top executive officer, defendant Hirsch. Defendant Lustman, who was responsible for overseeing the Company's finances and operations, was also responsible for projecting and evaluating the effects of competition and the JIT program. Defendant Scipione, who was responsible for communications with shareholders, analysts and the press, was also aware of the JIT program and its expected effects. All defendants knew that disclosure of the JIT program, and the severity of the competitive pressures that had led to its adoption, would immediately and significantly depress the market price of USSC's stock on the NYSE.

28. Despite their knowledge of the fierce competition faced by USSC, the development and implementation of the JIT program, and its expected material effects on USSC's financial performance and prospects, none of the Individual Defendants, nor any other Company officer, director or employee, disclosed any information concerning the Company's increasing concern about competitive pressures, or its decision to develop and implement the JIT program, until April 5, 1993. The effects of the program on USSC's short- and long-term financial results were not disclosed until after the market closed on April 7, 1993, at which point the Company's stock dropped over 15 points in a single day of trading. None of the Individual Defendants, nor any other Company officer, director or employee disclosed truthful information concerning the JIT program to William Chanoff, who was known by defendants to be particularly interested in the Company's sales force and asked about it regularly, until April 14, 1993, when defendant Scipione finally admitted to him that the program

had been in place for over a year. Instead, and as is described in more detail below, throughout 1992 and the first quarter of 1993 defendants continued to tout the abilities of the Company's internal sales force and brag about the apparent growth in its sales figures, while downplaying the severity of the competition facing USSC and omitting any mention of the JIT program and its effects, thus rendering USSC's annual and quarterly reports, defendants' shareholder letters, press releases and communications with analysts and shareholders, including plaintiff William Chanoff, materially false and misleading, and damaging plaintiffs herein.

29. During 1992 and the first quarter of 1993, the four Individual Defendants took advantage of their material inside information concerning the increasingly fierce competitive pressures facing USSC, the JIT program, and the public's ignorance of that information, to sell an aggregate of 1,721,147 shares of their own USSC stock at prices that they knew they could not have obtained had the truth been publicly disclosed, and thereby reaped proceeds of over $155 million.

30. By the time that the JIT program and its effects were finally disclosed, the program had been in place for over a year and had already produced the initial short-term surge in sales described in paragraph 25(a) above, which—due to defendants' concealment of information concerning the implementation and effects of the JIT program—had misled analysts and shareholders, including William Chanoff, and caused them to believe, erroneously, that the Company was experiencing a sustainable growth in its sales and earnings.

Defendants' Misleading Statements and Omissions and Plaintiffs' Reliance Thereon

First Quarter 1992

31. On January 15, 1992, the price of USSC's common stock reached its all-time high of $134.50 on the NYSE. On or about January 16, 1992, USSC filed its report on Form 10-K for the fiscal year ended December 31, 1991 with the SEC, and reported sales of $844 and net income of $91.2 million, or $1.58 per share, for 1991. Net income and net income per share had risen 98% and 78%, respectively, compared to 1990.

32. On or about January 28, 1992, defendant Hirsch made a presentation to industry analysts wherein he expressed confidence that the Company's sales would grow in all areas and stated, among other things, that its greatest growth would come from sales of its laparoscopic products.

33. On or about February 21, 1992, defendants caused copies of USSC's 1991 Annual Report to be delivered by mail to USSC's shareholders, including William Chanoff. Inside the front cover, highlighted inside a box, the report stated, "USSC markets its products through its own highly trained technical sales force in the United States and 16 other countries . . . ."

34. At page 42 of the 1991 Annual Report, under the heading, "Management's Discussion and Analysis of Financial Condition and Results of Operations," USSC reported:

> In 1991, the Company achieved record sales of $844 million compared with sales of $514 million in 1990 and sales of $345 million in 1989.
>
> * * *
>
> The Company believes that ***sales increases have resulted primarily from*** the Company's product innovations, performance of its products, ***technical services provided by***

> *its sales force* and the production of educational materials and films related to its products.

(Emphasis added.)

35. In the letter to shareholders contained in the 1991 Annual Report to Shareholder, dated February 21, 1992, defendant Hirsch trumpeted, among other things, USSC's laparoscopic products, the growth in laparoscopic surgery, the training in laparoscopic techniques provided by the Company, USSC's smooth entry into the sutures market, and the growth in overseas sales. In the letter, Hirsch concluded:

> Once again, we welcome the future with optimism, enthusiasm and the conviction that USSC will continue to outperform its competition with innovative products and unsurpassed service.

No mention was made, anywhere in the 1991 Annual Report, of the increasingly fierce competition faced by USSC or its development of the JIT program as a response to that competition.

36. On or about March 10, 1992, defendant Scipione reported that a Wertheim Schroder analyst had raised her earnings estimates for USSC to $2.35 per share for 1992 and $3.15 per share for 1993. Scipione said nothing to cast doubt on the validity of these estimates. Instead, she impliedly endorsed them, stating that USSC's fundamentals looked "extremely bright" and that the laparoscopic market continues to experience explosive growth.

37. The public statements which were made and/or caused to be made by defendants during the first quarter of 1992, as described in more detail in paragraphs 31-36 above, were materially false and misleading, and omitted and concealed material information that defendants were obligated to disclose and that was necessary to make the statements made, in light of the circumstances under which they were made, not misleading, in that: (a) they created a rosy impression of

unlimited future growth in all areas without mentioning the increased competitive pressures that USSC was facing from Ethicon and others; (b) they omitted and concealed the fact that, in response to significantly increased competition, USSC had developed the JIT program, which was a significant departure from its historical direct distribution method; (c) they omitted and concealed the fact that the JIT program was expected to produce material adverse effects on the Company's finances, both in the short term and the long term; and (d) they projected, or endorsed projections, for 1993 sales and earnings, that lacked any reasonable basis in light of the expected adverse effects of increased competition and the JIT program.

38. During the first quarter of 1992, the Individual Defendants sold substantial quantities of their own USSC common stock on the following dates and at the following prices, which they could not have obtained but for their materially false and misleading statements and their omissions and concealment of material information as described in paragraphs 31-36 above:

Date	*Seller*	*Shares*	*Price*	*Proceeds*
01/20/92	Lustman	25,000	$122.50	$ 3,062,500
01/22/92	Hirsch	15,000	115.60	1,734,000
01/23/92	Lustman	41,200	119.83	4,936,996
01/23/92	Josefsen	5,000	120.27	601,350
01/24/92	Lustman	33,800	118.73	4,013,074
01/27/92	Lustman	1,000	119.15	199,150
01/28/92	Lustman	5,000	119.15	595,750
01/31/92	Lustman	68,000	119.04	8,094,720
02/03/92	Lustman	13,500	119.52	1,613,520
02/03/92	Josefsen	2,500	120.15	300,375
02/03/92	Hirsch	7,500	119.98	899,850
02/04/92	Lustman	12,500	119.42	1,492,750
02/05/92	Josefsen	3,523	120.50	424,522
02/25/92	Hirsch	17,500	105.60	1,848,000

Date	*Seller*	*Shares*	*Price*	*Proceeds*
02/26/92	Hirsch	30,000	110.27	3,308,100
02/27/92	Hirsch	7,500	113.98	854,850
02/28/92	Hirsch	2,500	113.90	284,750
03/04/92	Hirsch	2,500	110.00	275,000
03/17/92	Hirsch	42	107.75	4,526
	TOTAL			$34,543,783

39. Defendant Lustman publicly explained his sales of USSC common stock during this period as, "part of my estate planning, for tax purposes and part of a selling program," and added that he was "very bullish" about the market for laparoscopic surgery. This statement was materially false and misleading in that defendant Lustman in fact sold his stock when he did in order to obtain prices that he knew he could not have obtained but for defendants' materially false and misleading statements and omissions and concealment of material information as described in paragraphs 31-36 above.

40. In reliance upon defendants' false and misleading statements as detailed in paragraphs 31-36 and 39 above, and in ignorance of the material adverse information withheld by defendants, William Chanoff held his USSC stock through the first quarter of 1992 without selling or hedging, and advised the remaining plaintiffs to do the same, which they did.

Second Quarter 1992

41. On or about April 15, 1992, USSC reported sales of $277 million, net income of $29.7 million and net income per share of $.49 for the first quarter of 1992, an increase of 46%, 85% and 64%, respectively, over the sales, net income and net income per share for the comparable period in 1991.

42. Commenting on these results in a news release that defendants caused to be transmitted by wire in interstate commerce, defendant Hirsch stated, "[t]he explosive acceptance of USSC's expanding laparoscopic line continues to revolu-

tionize surgery. Minimally invasive hysterectomy, appendectomy and hernia repair are now possible and, together with gallbladder removal, are propelling sales and earnings to new highs . . . ."

43. On or about April 15, 1992, defendants caused copies of USSC's 1992 First Quarter Report to be delivered by mail to USSC's shareholders, including William Chanoff. In a letter to shareholders included in the 1992 First Quarter Report, defendant Hirsch stated:

> First quarter sales increased 46% and net income and income per share climbed 84% and 69%, respectively, over the same period last year. Continued strong sales of core surgical staplers and laparoscopic products contributed significantly to this growth, and sales of our fledgling suture line increased impressively.
>
> * * *
>
> We look forward to another successful year for the company.

44. On or about May 5, 1992, defendant Hirsch represented, at a health care seminar sponsored by Alex, Brown, that the Company "would go over $1 billion in revenues" in 1992 and told analysts that all of USSC's product areas were growing.

45. On or about June 25, 1992, Hirsch represented that USSC expected to be on the high side of earnings projections for the second quarter of 1992. Hirsch added that the Company was "looking for a very good second half" of 1992 and was comfortable with analysts' full-year earnings estimates of $2.35 to $2.45 per share. In addition, Hirsch downplayed the strength of the competition USSC felt from Ethicon, and stated that USSC's annual revenues would soar about 40% over last year, "way north of a billion dollars." According to Hirsch: "I think we've got a very good story to tell."

46. At various times during the second quarter of 1992, including but not limited to May 13, 1992, William Chanoff communicated directly with defendant Scipione by interstate telephone, during which conversations he routinely made inquiries concerning the Company's sales force. Defendant Scipione consistently remarked that the Company's sales force, sales and R&D efforts were doing very well and that she was comfortable with analysts' favorable earnings projections. She never once mentioned the JIT program.

47. Defendants' public statements during the second quarter of 1992, as well as defendant Scipione's direct statements to William Chanoff, made on behalf of USSC and its senior management, as described in more detail in paragraphs 41-46 above, were materially false and misleading, and omitted and concealed material information that defendants were obligated to disclose and that was necessary to make the statements made, in light of the circumstances under which they were made, not misleading, in that: (a) they created a rosy impression of unlimited future growth in all areas without mentioning the increased competition that USSC was facing from Ethicon and others; (b) they omitted and concealed the fact that, in response to significantly increased competition, USSC had developed and implemented the JIT program, which was a significant departure from its historical direct distribution method; (c) they omitted and concealed the fact that the JIT program was expected to produce material adverse effects on the Company's finances, both in the short term and the long term; and (d) they omitted and concealed the fact that at least a portion of the Company's expected sales in 1992 would represent a temporary surge as the distributors purchased their initial inventories—later termed "pipeline fill" by one analyst—followed by a slump in sales in 1993 as the end users allowed their own inventories to deplete before beginning to reorder from the distributors.

48. During the second quarter of 1992, the Individual Defendants sold substantial quantities of their own USSC

common stock on the following dates and at the following prices, which they could not have obtained but for their materially false and misleading statements and their omissions and concealment of material information as described in paragraphs 31-36, 39, and 41-46 above:

Date	*Seller*	*Shares*	*Price*	*Proceeds*
05/04/92	Hirsch	26,500	$108.29	$ 2,869,690
05/05/92	Hirsch	17,500	110.24	1,929,200
05/06/92	Hirsch	4,500	109.63	493,340
05/07/92	Hirsch	5,500	106.40	585,200
05/08/92	Hirsch	6,000	104.15	624,900
05/11/92	Hirsch	2,500	106.90	267,250
05/12/92	Hirsch	1,500	106.56	159,840
05/13/92	Hirsch	500	105.52	52,760
05/14/92	Josefsen	3,000	104.70	314,100
05/14/92	Hirsch	2,000	104.70	209,400
05/15/92	Josefsen	3,000	105.24	315,720
05/15/92	Hirsch	2,000	105.24	210,480
05/18/92	Josefsen	3,300	107.33	354,189
05/18/92	Hirsch	2,200	107.33	236,126
05/19/92	Josefsen	5,800	107.06	620,948
05/19/92	Hirsch	4,200	107.06	449,652
05/20/92	Josefsen	8,700	108.64	945,168
05/20/92	Hirsch	6,300	108.64	684,432
05/21/92	Josefsen	7,540	107.62	811,455
05/21/92	Hirsch	5,460	107.62	587,605
05/22/92	Josefsen	2,900	107.14	310,706
05/22/92	Hirsch	2,100	107.14	224,994
05/26/92	Josefsen	4,292	105.82	454,179
05/26/92	Hirsch	3,108	105.82	328,889
05/27/92	Josefsen	5,858	106.20	622,120
05/27/92	Hirsch	4,242	106.20	450,500
05/28/92	Josefsen	8,700	107.92	938,904
05/28/92	Hirsch	6,300	107.92	679,896
05/29/92	Josefsen	21,910	111.66	2,446,471
05/29/92	Hirsch	15,590	111.66	1,740,779

Date	*Seller*	*Shares*	*Price*	*Proceeds*
06/01/92	Hirsch	20,000	111.10	2,222,000
06/03/92	Hirsch	10,000	110.95	1,109,500
06/04/92	Hirsch	15,000	114.80	1,722,000
06/04/92	Scipione	16,105	114.40	1,842,412
06/04/92	Josefsen	6,000	114.40	686,400
06/05/92	Hirsch	1,000	114.90	114,900
06/05/92	Josefsen	2,000	114.90	229,800
06/09/92	Hirsch	500	110.90	55,450
06/09/92	Josefsen	1,000	110.90	110,900
06/10/92	Hirsch	600	107.23	64,338
06/10/92	Josefsen	1,200	107.23	128,676
06/11/92	Hirsch	1,200	107.33	128,796
06/11/92	Josefsen	2,400	107.33	257,592
06/12/92	Hirsch	600	107.27	64,362
06/12/92	Hirsch	23	108.38	2,493
06/12/92	Josefsen	1,200	107.27	128,724
06/15/92	Hirsch	1,100	105.49	116,039
06/15/92	Josefsen	2,200	105.49	232,078
06/16/92	Hirsch	1,000	105.54	105,540
	TOTAL:			$30,240,893

49. In reliance upon defendants' false and misleading statements as detailed in paragraphs 31-36, 39, and 41-46 above, and in ignorance of the material adverse information withheld by defendants, William Chanoff held his USSC stock through the second quarter of 1992 without selling or hedging, and advised the other plaintiffs to do the same, which they did.

Third Quarter 1992

50. On or about July 15, 1992, USSC reported sales of $304.8 million, net income of $34.8 million and net income per share of $.58 for the second quarter of 1992, an increase of 50%, 64% and 57%, respectively, over the sales, net

income and net income per share for the comparable period in 1991.

51. Commenting on these results in a news release, dated July 15, 1992, that defendants caused to be transmitted by wire in interstate commerce, defendant Hirsch stated:

> The company's laparoscopic sales continue to explode as its expanding product line allows surgeons to bring minimally invasive techniques to a host of gynecologic, general, lung and bowel procedures, such as hysterectomy, hernia repair gall bladder removal, adhesions and appendectomy. The continued growth in both sales and earnings are a result of the laparoscopic revolution, coupled with strength in the company's core stapling product line.

52. On or about July 15, 1992, defendants caused copies of USSC's 1992 Second Quarter Report to be delivered by mail to USSC's shareholders, including William Chanoff. In a letter to shareholders included in the 1992 Second Quarter Report, defendant Hirsch stated:

> United States Surgical Corporation's core stapling business and new suture line continued to grow impressively, but the company's laparoscopic sales exploded.
>
> * * *
>
> USSC's phased introduction of sutures continues successfully, and inventory levels are being increased significantly. *By year end, there will be sufficient inventory to support sales by our entire 1000 member sales force.*
>
> * * *
>
> With all three of our product lines performing well and significant growth opportunities ahead, we look forward to an exciting second half of 1992.

(Emphasis added.)

53. On or about July 20, 1992, defendant Scipione was quoted in a Dow Jones report, transmitted by wire in interstate commerce, as stating that rumors that the Company's inventory had grown too large were inaccurate and failed to take into account the Company's push into the sutures market. Scipione said that a large inventory of sutures was necessary to meet the demand for sutures *the sales force had created.* (Emphasis added.)

54. On or about July 31, 1992, shares of USSC temporarily declined in price due to rumors that USSC had excessive inventory and that its rival Ethicon was gaining market share. Defendant Scipione, however, stated that none of the talk was true. According to a Dow Jones report, transmitted by wire in interstate commerce on July 31, 1993, "the high sutures inventory is necessary, company officials have said, *as U.S. Surgical's sales force pursues the extremely varied sutures marketplace.*" (Emphasis added.) The report added, "Company officials also have said that claims of market share gains by Ethicon typically refer to long-time customers of their products."

55. On or about August 11, 1992, after a day of heavy trading and downward pressure on USSC's stock price, defendant Scipione denied that the price movement signified any change in the Company's prospects, stating, "[W]hat is our long-term potential? I think it looks the way it did yesterday and six months ago."

56. At various times during the third quarter of 1992, including but not limited to August 11 and 12, 1992, William Chanoff communicated directly with defendant Scipione by interstate telephone, during which conversations he routinely made inquiries concerning the Company's sales force. Defendant Scipione consistently remarked that the Company was doing very well and never once told William Chanoff that USSC had recognized the severity of the competition from Ethicon and others and consequently had implemented the JIT program.

57. USSC's public statements during the third quarter of 1992, as well as defendant Scipione's direct statements to William Chanoff, made on behalf of USSC and its senior management, as described in more detail in paragraphs 51-56 above, were materially false and misleading, and omitted and concealed material information that defendants were obligated to disclose and that was necessary to make the statements made, in light of the circumstances under which they were made, not misleading, in that: (a) they created a rosy impression of unlimited future growth in all areas without mentioning the increased competition that USSC was facing from Ethicon and others; (b) they falsely denied that the competition from Ethicon was significant or that USSC's prospects had changed; (c) they omitted and concealed the fact that, in response to significantly increased competition, USSC had developed and implemented the JIT program, which was a significant departure from its historical direct distribution method; (d) they omitted and concealed the fact that the JIT program was expected to produce material adverse effects on the Company's finances, both in the short term and the long term; (e) they omitted and concealed the fact that at least a portion of the Company's expected sales in 1992 would represent a temporary surge as the distributors purchased their initial inventories followed by a slump in sales in 1993 as the end users allowed their own inventories to deplete before beginning to reorder from the distributors.

58. During the third quarter of 1992, the Individual Defendants sold substantial quantities of their own USSC common stock on the following dates and at the following prices, which they could not have obtained but for their materially false and misleading statements and their omissions and concealment of material information as described in paragraphs 31-36, 39, 41-46 and 51-56 above:

Date	*Seller*	*Shares*	*Price*	*Proceeds*
07/20/92	Hirsch	1,401	$ 94.75	$ 132,744
07/20/92	Hirsch	5,000	94.65	473,250
07/21/92	Hirsch	5,000	95.46	477,300
07/22/92	Hirsch	10,000	93.52	935,200
07/23/92	Hirsch	2,500	95.64	239,100
07/24/92	Hirsch	7,500	94.40	708,000
07/24/92	Hirsch	2,000	95.00	190,000
07/27/92	Hirsch	10,000	94.95	949,500
07/28/92	Hirsch	4,949	96.75	478,816
07/28/92	Hirsch	28,500	95.35	2,717,475
07/28/92	Josefsen	31,500	95.34	3,003,210
07/29/92	Hirsch	16,750	94.35	1,580,363
07/29/92	Josefsen	3,150	95.42	300,573
07/30/92	Hirsch	5,905	94.00	555,070
07/30/92	Hirsch	55,153	92.32	5,091,725
07/30/92	Josefsen	2,774	94.00	260,756
07/30/92	Josefsen	74,622	92.32	6,889,103
07/31/92	Hirsch	23,332	90.35	2,108,046
07/31/92	Hirsch	100	90.15	9,015
07/31/92	Josefsen	31,568	90.35	2,852,169
08/03/92	Josefsen	60,775	91.13	5,538,426
08/03/92	Hirsch	49,725	91.13	4,531,440
08/05/92	Hirsch	115,000	84.88	9,761,200
08/06/92	Hirsch	65,000	84.32	5,480,800
08/25/92	Hirsch	9,000	76.61	689,490
08/26/92	Hirsch	5,000	77.45	387,250
TOTAL:				$56,340,020

59. In August, 1992, an article in Barron's magazine revealed the July sales of USSC stock by defendant Hirsch. When asked to explain these sales, a Company spokesperson, with the knowledge and authorization of defendant Hirsch, stated that they were intended to enable Hirsch "to purchase property and other things that make him a happy man." In addition, Scipione told Chanoff by interstate telephone in August, 1992, that defendant Hirsch simply wanted to enjoy

the fruits of his labors, and that other USSC officers were merely taking advantage of what was, for many of them, their first significant opportunity to turn their stock into cash.

60. These statements were materially false and misleading in that defendant Hirsch and other USSC officers in fact sold their stock when they did in order to obtain prices that they knew they could not have obtained but for defendants' materially false and misleading statements and omissions and concealment of material information as described in paragraphs 31-36, 39, 41-46 and 51-56 above.

61. In reliance upon defendants' false and misleading statements as detailed in paragraphs 31-36, 39, 41-46, 51-56 and 59 above, and in ignorance of the material adverse information withheld by defendants, William Chanoff held his USSC stock through the third quarter of 1992 without selling or hedging, and advised the remaining plaintiffs to do the same, which they did.

Fourth Quarter 1992

62. On or about October 2, 1992, William Chanoff called USSC by interstate telephone and spoke to defendant Scipione concerning a decline in the Company's stock price. Defendant Scipione attributed the decline to short selling and told William Chanoff that things were going well at USSC. She did not mention the JIT program.

63. On or about October 9, 1992, in *reliance* on defendants' false and misleading statements as described in paragraphs 31-36, 39, 41-46, 51-56, 59 and 62 above, particularly the reassurances he had received a few days earlier by telephone from defendant Scipione, and in ignorance of the material adverse information withheld by defendants, particularly that USSC had recognized the severe competitive pressures it was facing, had implemented the JIT program, was by then relying heavily on it, and was experiencing the expected temporary boost to sales and profits, William Chanoff purchased

an additional 2000 shares of USSC common stock at artificially inflated prices of $59 to $59.375, caused by defendants' materially false and misleading statements and omissions, for a total of $118,375.

64. On at least three occasions during October, 1992, a stockbroker visited or spoke with William Chanoff to recommend that he sell some or all of his USSC stock and/or hedge his position to safeguard against further declines in the market price of the stock. In *reliance* on defendants' false and misleading statements as described in paragraphs 31-36, 39, 41-46, 51-56, 59 and 62 above, particularly the reassurances he had received earlier that month from defendant Scipione, and in ignorance of the material adverse information withheld by defendants, particularly that USSC had recognized the severe competitive pressures that it was facing, had implemented the JIT program, was by then relying heavily on it, and was experiencing the expected temporary boost to sales and profits, William Chanoff refrained from selling or hedging any of his USSC stock at that time, and advised the other plaintiffs to do the same, which they did.

65. On or about October 16, 1992, defendants caused copies of USSC's 1992 Third Quarter Report to be delivered by mail to USSC's shareholders, including William Chanoff. The 1992 Third Quarter Report announced sales of $293 million, net income of $37 million, and net income per share of $.61 for the third quarter of 1992, an increase of 41%, 45% and 42%, respectively, over the sales, net income, and net income per share for the comparable period in 1991. In the letter to shareholders included in the Third Quarter Report, defendant Hirsch spoke glowingly of the Company's laparoscopy products and sutures, and concluded:

> With significant opportunities in laparoscopy, our continued dominance in surgical stapling and the encouraging acceptance of our sutures, management looks to the future with confidence.

On October 20, 1992, USSC's stock closed at $70.375 on the NYSE, almost 25% higher than its price earlier the same month.

66. On or about November 25, 1992, William Chanoff spoke with defendant Scipione twice by interstate telephone. William Chanoff asked, in substance, whether the Company had experienced any changes or developments which could adversely affect its finances or prospects. He also inquired, as was his custom, about the Company's sales force. Scipione responded, in substance, that sales were moving along well, that the Company was not worried about competition, and that there was nothing material to report. She did not tell William Chanoff about the JIT program.

67. On or about December 9, 1992, William Chanoff spoke to defendant Scipione by interstate telephone concerning USSC's prospects for the remainder of 1992 and for 1993. He asked Scipione, in substance, whether the Company had any problems, and also inquired as to its sales force. In response, Scipione stated that USSC's business was moving along well. She did not tell William Chanoff about the JIT program, nor that sales were expected to slump in 1993 after the initial "pipeline fill" effect of the JIT program.

68. USSC's public statements during the fourth quarter of 1992, as well as defendant Scipione's direct statements to William Chanoff, made on behalf of USSC and its senior management, as described in more detail in paragraphs 62 and 65-67 above, were materially false and misleading, and omitted and concealed material information that defendants were obligated to disclose and that was necessary to make the statements made, in light of the circumstances under which they were made, not misleading, in that: (a) they created a rosy impression of unlimited future growth in all areas without mentioning the increased competition that USSC was facing from Ethicon and others; (b) they omitted and concealed the fact that, in response to significantly increased competition, USSC had developed, implemented, and was by then

heavily relying on the JIT program, which was a significant departure from its historical direct distribution method; (c) they omitted and concealed the fact that the JIT program was expected to produce material adverse effects on the Company's finances, both in the short term and the long term; and (d) they omitted and concealed the fact that a substantial portion of the Company's sales in the fourth quarter of 1992 represented a temporary surge as the distributors purchased their initial inventories, and would be followed by a slump in sales in 1993.

69. During the fourth quarter of 1992, the Individual Defendants sold substantial quantities of their own USSC common stock on the following dates and at the following prices, which they could not have obtained but for their materially false and misleading statements and their omissions and concealment of material information as described in paragraphs 31-36, 39, 41-46, 51-56, 59, 62, and 65-67 above:

Date	*Seller*	*Shares*	*Price*	*Proceeds*
11/10/92	Hirsch	20,000	$64.99	$ 1,299,800
11/11/92	Hirsch	1,800	65.93	118,674
11/12/92	Hirsch	13,200	65.73	876,636
11/13/92	Hirsch	10,000	65.49	654,900
11/16/92	Hirsch	10,000	66.07	660,700
11/17/92	Hirsch	16,500	66.04	1,089,660
11/18/92	Hirsch	21,500	65.08	1,399,220
11/19/92	Hirsch	17,000	66.79	1,135,430
11/20/92	Hirsch	10,000	68.06	680,600
11/23/92	Hirsch	15,000	68.15	1,022,250
11/24/92	Josefsen	12,500	69.50	868,750
11/25/92	Josefsen	7,500	68.29	512,175
11/30/92	Josefsen	9,800	66.57	652,386
12/01/92	Josefsen	20,200	64.80	1,308,960
12/07/92	Hirsch	20,500	68.96	1,413,680
12/11/92	Scipione	8,000	69.27	554,160
12/14/92	Scipione	4,200	65.00	273,000
12/14/92	Lustman	42,000	65.00	2,730,000

Date	*Seller*	*Shares*	*Price*	*Proceeds*
12/14/92	Josefsen	49,498	65.21	3,227,765
12/14/92	Hirsch	85,502	65.24	5,578,150
12/15/92	Josefsen	11,500	66.77	767,855
12/15/92	Hirsch	34,500	66.77	2,303,565
12/16/92	Josefsen	13,002	66.05	858,782
12/16/92	Hirsch	29,998	66.05	1,981,368
	TOTAL:			$31,968,466

70. In reliance upon defendants' false and misleading statements as detailed in paragraphs 31-36, 39, 41-46, 51-56, 59, 62, and 65-67 above, and in ignorance of the material adverse information withheld by defendants, William Chanoff held his USSC stock—including the 2000 additional shares he purchased in October—through the fourth quarter of 1992 without selling or hedging, and advised the remaining plaintiffs to do the same, which they did.

First Quarter 1993

71. On January 19, 1993, USSC's common stock closed at the price of $69.375 on the NYSE. After the close of the market that day, USSC reported record sales of $1.2 billion, net income of $138.9 million, and net income per share of $2.32 for 1992, an increase of 42%, 52% and 46%, respectively, over the figures for 1991. For the fourth quarter of 1992, USSC reported sales of $322 million, net income of $37.9 million and net income per share of $.64, an increase of 33%, 30% and 30%, respectively, over the sales, net income and net income per share reported for the fourth quarter of 1991. Commenting on these results in a news release transmitted by wire in interstate commerce, defendant Hirsch stated, "The rapid acceptance of USSC's expanding laparoscopic line, supported by continued strength in its core surgical stapling line, and our best suture quarter to date, resulted in sales and earnings reaching new highs for both the fourth quarter and the year ended 1992."

72. After the 1992 results were released on January 19, 1993, defendant Scipione stated that the Company was aware of, and felt "comfortable" with, projections by analysts that USSC's 1993 sales would be in the range of $1.425 billion to $1.53 billion, and that USSC's 1993 net income per share would be "$3.00 plus or minus a few cents."

73. As a result of these statements, the price of USSC's stock on the NYSE rose sharply, closing at $74 per share on January 21, 1993. In addition, numerous analysts raised their own 1993 sales and earnings estimates for USSC and predicted that the price of its stock would continue to rise. For example, on January 20, 1993, Wertheim Schroder analyst Lorraine Schwartz told investors that USSC's stock was an "outstanding 'buy' " and could reach $85-90 per share by year end. On January 22, 1993, PaineWebber analyst David Lothson reported that he was raising his 1993 sales estimate for USSC from $1.49 billion to $1.51 billion. On January 26, 1993, Kidder, Peabody analyst Ruth Alon said that investors "should find comfort" in USSC's fourth quarter 1992 performance, that its earning should increase 30% in 1993, and that its stock price could rise to "the high 80s to low 90s." And on February 10, 1993, Legg Mason analyst Eugene Melnitchenko issued a purchase recommendation for USSC. Melnitchenko stated, among other things (and based at least in part on information obtained from the Company), that USSC has "one of the best trained and most aggressive salesforce in the medical products industry."

74. On or about February 17, 1993, defendant Scipione wrote a letter to William Chanoff and caused it to be delivered to him by mail. In the letter, she stated, "As you know, most analysts project USSC's sales to grow more than 15% in the next two to three years." Defendant Scipione said nothing to cast doubt on this projection, thereby impliedly endorsing it on behalf of the Company.

75. On or about March 8, 1993, William Chanoff received and read USSC's 1992 Annual Report, which defendants

caused to be delivered to him and other USSC stockholders by mail. At pages 15-16, under the heading, "A Step Forward into the World of Sutures," the Company commented:

> USSC markets its suture line through the same certified stapling technicians (CSTs) that handle the company's staplers and laparoscopic products, making the sales calls more productive . . . . Customers, for their part, appreciate being able to deal with a single representative for all of their wound closure needs.
>
> * * *
>
> Many hospitals are moving as much business as possible to one supplier. In being able to offer a full range of wound closure products—staplers, laparoscopic instruments and sutures—USSC becomes a more accommodating source for its customers.

76. At page 46, under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations," USSC stated, just as it had a year earlier:

> The Company believes that sales increases have resulted primarily from the Company's product innovations, performance of its products, *technical services provided by its sales force* and the production of educational materials and films related to its products.

(Emphasis added.) There was no mention in the 1992 Annual Report of the JIT program, which by that time was not only being relied on heavily by USSC but was being accelerated.

77. On or about March 15, 1993, defendant Scipione wrote a letter to William Chanoff and caused it to be delivered to him by mail. In the letter, she stated:

> Needless to say, at our current rate of $1.2 billion, we can no longer grow at 40% to 50% per annum. Let's take a more conservative approach, using a 15% growth rate per annum over the next five years.

78. During March of 1993, the price of USSC's common stock fell below $60 per share on the NYSE and continued to sink. Fearing that he would be forced to liquidate a portion of his stock, which he held in margin accounts, as a result of margin calls, William Chanoff contacted USSC to inquire as to the reasons for the decline. On or about March 19, 1993, he spoke to defendant Scipione by interstate telephone, and asked, in substance, whether the Company had problems of any kind, including legal or accounting problems, or had suffered any negative developments. William Chanoff also inquired, as was his custom, about the Company's *sales force.* Scipione responded, in substance, that the Company was on course and would weather any uncertainties caused by the Clinton Administration's health care initiatives. She said nothing about the JIT program.

79. On or about March 22, 1993, William Chanoff held two interstate telephone conversations with defendant Scipione. He pursued the question of the reasons for the downturn in the Company's stock price, and asked, in substance, whether any changes had affected the Company. Scipione stated, in substance, that there had been no changes and the business was going fine. Again, she said nothing about the JIT program.

80. On or about March 26, 1993, William Chanoff again called defendant Scipione by interstate telephone to discuss USSC's stock price. He also inquired about recent sales of stock by defendants Hirsch and Josefsen. William Chanoff asked, in substance, whether there was anything wrong with the Company. He also inquired about the sales force. Defendant Scipione once again responded, in substance, that USSC was doing very well. As for the insider stock sales, Scipione said that Hirsch and Josefsen "want to enjoy life while they are still young." No mention was made of the JIT program or its effects, including the drop-off in sales and profits that defendants knew would be felt in the second quarter of 1993.

81. On March 29, 1993, USSC's stock closed at a 52-week low of $52.375 on the NYSE. The following day, Hambrecht

& Quist analyst Kurt Kruger, relying on information provided to him by the Company, issued what he referred to as a "battle-weary buy" recommendation for USSC stock. Kruger stated in his report that USSC's per-share earnings would grow about 30% in 1993, and that sales would grow 20% to 25%. Kruger added that USSC would "wring out more profitability from its sales, as its 1992 operating margin of 17% was at the low end of the scale for medical device firms."

82. USSC's public statements during the first quarter of 1993, as well as defendant Scipione's direct statements to William Chanoff, made on behalf of USSC and its senior management, as described in more detail in paragraphs 71-81 above, were materially false and misleading, and omitted and concealed material information that defendants were obligated to disclose and that was necessary to make the statements made, in light of the circumstances under which they were made, not misleading, in that: (a) they created a rosy impression of unlimited future growth in all areas without mentioning the increased competition that USSC was facing from Ethicon and others; (b) they omitted and concealed the fact that, in response to fierce competition, USSC developed, implemented, had been heavily relying on and was by then accelerating the JIT program, which was a significant departure from its historical direct distribution method; (c) they omitted and concealed the fact that the JIT program was expected to produce material adverse effects on the Company's finances, both in the short term and the long term; (d) they omitted and concealed the fact that a portion of the Company's sales in later 1992 and an even greater portion of its sales in the first quarter of 1993 represented a temporary surge as the distributors purchased their initial inventories, which would be followed by a sharp slump in sales beginning in the second quarter of 1993; (e) they projected, or endorsed projections, for 1993 sales and income that lacked any reasonable basis when made in light of the anticipated effects of the JIT program; and (f) they omitted and concealed the fact that the Individual Defendants sold their personal USSC stock

in order to obtain prices they knew they could not have obtained but for their fraud.

83. During the first quarter of 1993, the Individual Defendants sold substantial quantities of their own USSC common stock on the following dates and at the following prices, which they could not have obtained but for their materially false and misleading statements and their omissions and concealment of material information as described in paragraphs 31-36, 39, 41-46, 51-56, 59, 62, 65-67 and 71-81 above:

Date	*Seller*	*Shares*	*Price*	*Proceeds*
02/19/93	Hirsch	31,250	$63.83	$ 1,994,688
03/08/93	Hirsch	6,000	59.34	356,040
03/09/93	Hirsch	4,300	59.99	257,957
	TOTAL:			$ 2,608,685

84. During February and March, 1993, William Chanoff was asked on at least four separate occasions by a stockbroker to consider selling some or all of his USSC stock and that of the other plaintiffs, or hedging their positions, as a safeguard against further declines in the market price of the Company's stock. However, defendant Scipione, to whom William Chanoff reported these conversations, told him by interstate telephone that the Company was on course and that the stockbroker probably did not know very much about USSC. Consequently, in reliance upon defendants' false and misleading statements, and in ignorance of the material adverse information withheld by defendants, William Chanoff held all of his USSC stock through the first quarter of 1993 without selling or hedging, and advised the remaining plaintiffs to do the same, which they did.

Disclosure of the JIT Program and its Effects

85. On April 5, 1993, Oppenheimer & Co. analyst Glenn Reicin released a report disclosing that USSC had embarked on a "meaningful departure . . . from its long-time strategy

of selling direct" by "expanding" its use of third-party distributors to accommodate the needs of hospitals wishing to reduce inventory carrying costs. Reicin stated that USSC's initial orders from distributors were likely to be recognized as revenues in the first half of 1993, boosting apparent sales figures dramatically but representing "pipeline fill." Reicin added that distributors typically take a "cut" of 5% to 8% of sales to hospitals, which would cause USSC's profit margins to suffer in the long term. Reicin added that the move to the JIT system was in part a reaction to competition from Ethicon.

86. In response to Reicin's report, defendant Scipione confirmed that the Company had undergone an "expansion" in its use of distributors during the first quarter of 1993, but declined to provide details as to the number of customers involved in the JIT program. Scipione also stated that USSC "began" offering the JIT program in the fourth quarter of 1992. She refused to quantify the Company's distributor sales or to project the impact of the program on the Company's profit margins. The next day, April 6, 1993, Hambrecht & Quist analyst Kurt Kruger cut his estimate of USSC's earnings for the year, but only by 15¢ per share, projecting earnings of $2.85 per share for 1993.

87. Defendant Scipione's April 5, 1993, statements, made on behalf of USSC and its senior management, though they finally admitted the existence of the JIT program and certain of its adverse effects, were materially false and misleading, and omitted and concealed material information that defendants were obligated to disclose and that was necessary to make the statements made, in light of the circumstances under which they were made, not misleading, in that: (a) they falsely stated that USSC had begun offering the JIT program in the fourth quarter of 1992, when in fact the program had been developed and implemented much earlier; (b) they omitted and concealed the fact that the Company's reported sales figures for the fourth quarter of 1992 as well as its projected

sales figures for the first quarter of 1993 were artificially inflated due to the "pipeline fill" effect of the JIT program; (c) they failed to disclose that discounts of up to 15%, rather than the 5% to 8% reported by Oppenheimer & Co., were given to distributors under the JIT program; and (d) they omitted and concealed the fact that USSC had projected and was well aware that the adverse effects of the JIT program would be sharply felt beginning in the second quarter of 1993 —already underway—and that sales and net income for the second quarter were expected to slump dramatically.

88. William Chanoff was unaware of the partial disclosures concerning the JIT program and its effects until the evening of April 6, 1993, after the market closed. On the morning of April 7, 1993, William Chanoff placed an interstate telephone call to defendant Scipione. Defendant Scipione said that USSC was "very comfortable" with analysts' projections of $.61 to $.65 in net income per share for the first quarter of 1993, and with analysts' current projections for the remainder of 1993. In response to William Chanoff's questions concerning the price of USSC stock, Scipione said that the Company did not have anything negative to report. These statements were materially false and misleading in that they omitted and concealed the significance of the JIT program, its "pipeline fill" effect on the Company's reported 1992 earnings and projected first quarter 1993 earnings, and its expected dramatic adverse impact on the Company's sales and earnings beginning in the second quarter of 1993, which was already underway, and they projected, or endorsed projections, for 1993 sales and income that lacked any reasonable basis when made.

89. Later on April 7, 1993, when the market price of USSC's stock continued to sink, defendant Scipione stated publicly that the Company remained "comfortable" with analysts' earnings estimates of $.61 to $.64 per share for the first quarter of 1993, and that it was "still trying to get a handle" on the effects of the JIT program on the Company's profit

margins. Still later that day, she stated that the Company would provide "guidance to Wall Street" on the "anticipated" impact of its distributorship policy when it released its first-quarter results on April 15, 1993.

90. William Chanoff had been telephoned or visited by a stockbroker on each of April 1, 5, 6 and 7, 1993, and asked again to consider selling some or all of his USSC stock or hedging his position to guard against further declines in its market price. In reliance upon defendants' false and misleading statements as detailed in paragraphs 31-36, 39, 41-46, 51-56, 59, 62, 65-67, 71-81, 84, 86 and 88-89 above, and in ignorance of the material adverse information withheld by defendants, William Chanoff continued to hold all of his USSC stock without selling or hedging, and advised the remaining plaintiffs to do the same, which they did.

91. On April 7, 1993, USSC's stock closed at $46.625 per share on the NYSE. After the close of the market, USSC issued the following press release and caused it to be transmitted by wire in interstate commerce:

> Leon C. Hirsch, chairman of United States Surgical Corporation (NYSE: USS), in response to growing investor speculation, announced today that, "The company will release its earnings on April 15 at 4:15 p.m., and expects to report record sales and strong earnings."
>
> Mr. Hirsch added that, "*For approximately one year*, the company has been experimenting with a Just-In-Time (JIT) distributor program. As a result of the positive reaction of its test hospitals, the company *accelerated significantly its JIT program during the later part of the first quarter*. Many hospitals have reported that JIT can answer their need to reduce inventory levels and the costs connected with handling large inventories. JIT benefits USSC because the distributor handles hospital inventory, providing more time for our technical sales force to support our customers with training programs

and other teaching efforts. The new JIT distributor relationship also eliminates the distributors' incentive to push competing brands. Although *the short term sales profit impact of this program will be negative*, we believe long term JIT servicing will put us in a more competitive position in dealing with our customers."

When a hospital becomes part of the USSC JIT program, they identify the distributor they want to service them. The hospital then either sells its USSC inventory to this distributor or uses it up before ordering. USSC ships initial inventory to the distributor; when the hospital approaches minimal inventory, the distributor reorders product from USSC on a monthly basis to replace the product actually used by the hospital during the preceding month.

Mr. Hirsch added, "*The large number of JIT accounts added during the first quarter will result in significantly reduced sales for the second and third quarters of this year as hospitals use up their inventories.* The Company expects second quarter sales to be flat or slightly down from the prior year's comparable quarter, followed by an improving trend in the third quarter and a strong fourth quarter.

Despite the expected reduction in revenues short term, the Company will continue its aggressive surgical training programs and will expand further its R&D expenditures to ensure future growth. These continuing expenses will result in sharply down second quarter earnings. The company expects sequential earnings improvement in the third quarter and strong improvement in the fourth quarter. *EPS for the full year are expected to be down from the prior year's because the major negative aspects of this program should be absorbed in 1993*, but 1993 results should be solidly profitable." CONTACT: Mari-

anne Scipione, vice president, corporate communications of United States Surgical Corporation, 203-845-1404.

(Emphases added.)

92. USSC's April 7, 1993 press release, though it disclosed certain of the adverse effects of the JIT program, was materially false and misleading, and omitted and concealed material information necessary to make the statements made, under the circumstances in which they were made, not misleading, in that: (a) it falsely stated that the Company had only been "experimenting" with the JIT program, when in fact the Company had begun to rely heavily on the program by the fourth quarter of 1992; (b) it failed to disclose the discount of up to 15% given to distributors under the JIT program and the long term adverse effects of that discount on the Company's sales; (c) it omitted and concealed the fact that the Company's reported sales figures for the fourth quarter of 1992 and the first quarter of 1993 were artificially inflated due to the "pipeline fill" effect of the JIT program; and (d) it failed to disclose the magnitude of the slump in sales and earnings expected in the second and third quarters of 1993 and thereafter.

93. On April 8, 1993, as a direct result of the Company's additional partial disclosure of the JIT program and its adverse effects the evening before, the price of USSC's common stock on the NYSE opened sharply lower, and quickly fell even further on volume of over 8.4 million shares, to close at $31.375 per share, a drop of $15.25, almost one-third of the stock's value, from the close the previous day.

94. On April 9, 1993, the "Heard on the Street" column in the Wall Street Journal termed the JIT program "a major shift in the way [USSC] distributes its products" and noted that the Company was grappling with "stiff price competition from archrival Johnson & Johnson's Ethicon unit," with "changing practices among physicians," and with "cost-containment pressures from hospitals and the Clinton administration." The

column went on to note that "the extent of the company's move . . . away from direct sales took analysts by surprise" and raised "credibility issues." The column also stated that the JIT program "could blunt the impact of one of the biggest reasons analysts have cited in the past to buy Surgical—its vaunted sales force."

95. On April 14, 1993, William Chanoff spoke with defendant Scipione by interstate telephone. During this conversation, Scipione revealed to him, for the first time, that the JIT program had "started in the first quarter of 1992," that it had continued "relatively light" during the second and third quarters, and that it had become "heavy" during the fourth quarter of 1992. During the same conversation, Scipione stated, in response to William Chanoff's questions, that the Company expected to earn $.61 per share for the first quarter of 1993, $.03 for the second quarter, $.50 for the third quarter, and $.75 for the fourth quarter of 1993; that is, $1.89 per share for all of 1993, almost $1.00 per share less than projected by analysts, and endorsed by defendant Scipione on behalf of USSC, one week earlier.

Plaintiffs' Damages

96. Plaintiff William Chanoff has been damaged by defendants' misconduct in that:

(a) He declined to sell or hedge any of his USSC stock, as he would have done had he known the truth, from January 1, 1992 until April 9, 1993. Had he sold his 371,436 shares on January 15, 1992, he would have received proceeds of almost $50 million.

(b) He purchased an additional 2000 shares of USSC stock on or about October 9, 1992, at the artificially inflated price of over $59 per share, which he would not have done had he known the truth, and which cost him $118,375.

(c) He received margin calls in September and October, 1992, as a result of declines in the price of his USSC stock, which he met by selling other securities at a net loss of approximately $400,000.

(d) He received additional margin calls in April, 1993, as a result of the further decline in the price of his USSC stock, which he met in part by selling other securities at a net loss of over $100,000 and which led to the forced liquidation and/or sale of more than half of his USSC stock, at an average price of less than $31 per share, for proceeds of approximately $7.2 million.

(e) He has been left with 135,236 shares of USSC common stock which, as of June 30, 1993, had a market value of $27.50 per share or approximately $3.7 million.

(f) He has incurred significant tax liabilities and other debts, including margin debt, which could have been avoided had he known the truth about USSC, and he has been forced, in order to meet his tax liabilities and other debts, to sell or attempt to sell various pieces of real estate in a depressed market at "fire sale" prices. He faces the possibility of losing his business and his home and fears that he will be unable adequately to support his family.

(g) He has suffered considerable emotional distress and mental anguish, including but not limited to extreme stress, depression, feelings of betrayal, and anxiety concerning his ability to continue in business and provide for his family, accompanied by physical symptoms such as sleeplessness, loss of weight, elevated blood pressure and a worsening of the symptoms of diabetes, which required hospitalization in April, 1993.

97. Plaintiff David Chanoff has been damaged by defendants' misconduct in that:

(a) He declined to sell or hedge any of his USSC stock, as he would have done had he or William Chanoff known the

truth, from January 1, 1992 until April, 1993. Had he sold his 8900 shares on January 15, 1992, he would have received proceeds of $1,197,050.

(b) After selling approximately 1000 shares of his USSC stock in April, 1993, for living expenses, he has been left with approximately 7900 shares which, as of June 30, 1993, had a market value of $27.50 per share or $217,250.

98. Plaintiff Rachel Chanoff has been damaged by defendants' misconduct in that:

(a) She declined to sell or hedge any of her USSC stock, as she would have done had she or William Chanoff known the truth, from January 1, 1992 until April 12, 1993. Had she sold her 3436 shares on January 15, 1992, she would have received proceeds of $462,142.

(b) She received margin calls in April, 1993, as a result of declines in the price of her USSC stock, which she met by selling other securities at a net loss of approximately $34,000, and by selling her 3436 shares of USSC stock, at an average price of less than $30 per share, for proceeds of $102,413.

(c) She has incurred significant tax liabilities which could have been avoided had she or William Chanoff known the truth about USSC.

99. Plaintiff Harriet Fingerote has been damaged by defendants' misconduct in that:

(a) She declined to sell or hedge any of her USSC stock, as she would have done had she or William Chanoff known the truth, from January 1, 1992 until April 12, 1993. Had she sold her 20,000 shares on January 15, 1992, she would have received proceeds of $2,690,000.

(b) She received margin calls in April, 1993, as a result of the decline in the price of her USSC stock, which she met by selling other securities at a net loss of approximately $36,000,

and by selling her 20,000 shares of USSC stock, at the price of $29.875 per share, for proceeds of $597,500.

(c) She has incurred significant tax liabilities which could have been avoided had she or William Chanoff known the truth.

Defendants' Liability

100. USSC and each of the Individual Defendants had a duty to disseminate, in the Company's SEC filings, annual reports, quarterly reports, press releases and other public statements, as well as in private communications with shareholders, including William Chanoff, accurate and truthful information concerning USSC's business, operations, financial condition and prospects and to correct promptly any statements which were or had become false or misleading. USSC and each of the Individual Defendants also had a duty to disclose known material business changes and known material business trends which would affect the Company's earnings or financial condition or make past statements or projections concerning the Company false or misleading. With respect to William Chanoff, with whom defendants had engendered a unique relationship of trust and confidence, defendants had a duty, when they undertook to speak directly with him, to speak accurately, fully and completely, and to disclose truthful information concerning the matters known to be of special significance to him, including the Company's sales force.

101. Each of the Individual Defendants knew or should have known, but for his or her reckless disregard of the truth, of the false and misleading nature of his or her own statements, as detailed above, and that material adverse information concerning the Company was thereby concealed from its shareholders, including plaintiffs herein. In addition, each of the Individual Defendants knew or should have known, but for his or her reckless disregard of the truth, of the false and

misleading nature of USSC's annual and quarterly reports, press releases and other public statements, as detailed above, and that material adverse information concerning the Company was thereby concealed from its shareholders, including plaintiffs herein.

102. Each of the Individual Defendants had the power and influence, and exercised the power and influence, to cause USSC to issue the false and misleading SEC filings, annual and quarterly reports, press releases and other public statements detailed above and to omit and conceal adverse material information necessary to make the statements made in those reports not false and misleading.

103. In breach of their duties to USSC's shareholders, including plaintiffs herein, the Individual Defendants, acting in concert with one another and for the purpose of personal gain, made and caused USSC to make materially false and misleading statements of fact, and to omit and conceal material adverse information concerning the Company necessary to make the statements made not misleading. Defendants' misconduct was intended to and did maintain the market price of USSC's stock at an artificially high level and prevent it from falling, while they sold their own stock, to the level that would have resulted and did result when truthful information concerning the matters previously misrepresented and concealed was disclosed. Defendants' scheme permitted each of the Individual Defendants to dispose of significant portions of his or her personal USSC holdings at prices that could not have been obtained once the truth was disclosed, while depriving USSC's shareholders, including plaintiffs herein, of the opportunity to make informed decisions about their stock.

104. Defendants Hirsch and Scipione knew that William Chanoff was in his 80's and had had significant health problems, that he had a long history of involvement with USSC, that he had invested a substantial portion of his personal financial assets in USSC common stock, and that he had influenced family members and friends, including the other

plaintiffs herein, to invest substantial sums in USSC common stock as well. For these reasons, among others, defendant Hirsch and Scipione knew or should have known that their conduct, as alleged herein, created an unreasonable risk of causing emotional distress to William Chanoff and that such distress could result in illness and/or bodily harm.

105. All of the defendants herein are directly liable, jointly and severally, for plaintiffs' financial losses. In addition, USSC is liable for the misconduct of each Individual Defendant and all of plaintiffs' injuries resulting therefrom by virtue of the doctrine of *respondeat superior*, as each Individual Defendant's misconduct was committed within the course and scope of his or her employment by USSC. Further, each Individual Defendant is liable for the misconduct of the Company and all of plaintiffs' injuries resulting therefrom as a control person as that term is used in 15 U.S.C. §78t(a), as each Individual Defendant had and exercised the power and authority to cause USSC to engage in the wrongful conduct alleged above. Moreover, each Individual Defendant is liable as an aider and abettor of each other Individual Defendant, as each of them had actual knowledge of and lent substantial assistance to the misconduct of one another.

COUNT I: FRAUD
(Against All Defendants)

106. Plaintiffs repeat and reallege paragraphs 1-105 above as if fully set forth herein.

107. Between January 1, 1992, and April 14, 1993, defendants made and caused to made false representations of material fact concerning USSC.

108. Between January 1, 1992, and April 14, 1993, defendants made and caused to make made incomplete representations of material fact concerning USSC which failed to

include information necessary to make the statements made not misleading.

109. Between January 1, 1992, and April 14, 1993, defendants made and caused to be made material representations concerning the future of USSC which lacked any reasonable basis in fact when made and were not made in good faith.

110. Defendants knew or should have known, but for their reckless disregard of the truth, that their statements concerning USSC were false and/or misleading, knew or should have known, but for their reckless disregard of the truth, of the omitted information necessary to make their statements not misleading, and knew or should have known, but for their reckless disregard of the truth, that their representations concerning the future of USSC lacked any reasonable basis in fact and were not made in good faith.

111. Defendants' false statements, misleading statements, and forward-looking representations lacking any reasonable basis were intended to and did reach William Chanoff, either directly or through the media, and were believed and reasonably relied on by him and, indirectly, by the remaining plaintiffs herein. Plaintiffs herein were ignorant of the false and misleading nature of defendants' statements.

112. Defendants' false statements, misleading statements, and forward-looking representations lacking any reasonable basis induced all plaintiffs to refrain from selling any of their USSC stock and also induced plaintiff William Chanoff to purchase an additional 2000 shares of USSC stock on or about October 9, 1992.

113. Defendants' false statements, misleading statements, and forward-looking representations lacking any reasonable basis were intended to and did induce USSC's investors, including plaintiffs herein, to refrain from selling their USSC stock and/or to purchase additional USSC stock, thereby maintaining the market price of USSC's stock above the level it would have reached had truthful information been dis-

closed, and permitting the Individual Defendants to profit from their fraud by selling large quantities of their own USSC stock at artificially high prices which they had created and/or maintained.

114. As a result of defendants' fraud, plaintiffs were deprived of the opportunity to sell or hedge any of their USSC stock from January 1, 1992, until April 9, 1993, and were greatly damaged thereby.

COUNT II: FRAUD BY NONDISCLOSURE
(Against All Defendants)

115. Plaintiffs repeat and reallege paragraphs 1-105 as if fully set forth herein.

116. Between January 1, 1992, and April 14, 1993, defendants suppressed and concealed material information concerning USSC under circumstances which imposed upon them a duty of disclosure to William Chanoff, in that a unique relationship of truth and confidence existed between William Chanoff and defendants, who had superior knowledge and information concerning USSC's sales force and other matters known by them to be of particular concern to William Chanoff.

117. Defendants knew or should have known, but for their reckless disregard of the truth, of the material information that they suppressed and concealed from William Chanoff, knew or should have known, but for their reckless disregard of the truth, that it was of particular concern to him, and knew or should have known, but for their reckless disregard of the truth, of the trust and confidence that he placed in them.

118. Defendants' suppression and concealment of material information from William Chanoff was intended to induce and did induce all plaintiffs to refrain from selling or hedging any of their USSC stock and also induced plaintiff William Chanoff to purchase an additional 2000 shares of USSC stock

on or about October 9, 1992, while the Individual Defendants took advantage of their fraud to sell large quantities of their own USSC stock at the artificially high prices that they had created and/or maintained.

119. As a result of defendants' fraud, plaintiffs were deprived of the opportunity to sell or hedge any of their USSC stock from January 1, 1992, until April 9, 1993, and were greatly damaged thereby.

COUNT III: BREACH OF FIDUCIARY DUTIES
(Against All Defendants)

120. Plaintiffs repeat and reallege paragraphs 1-105 above as if fully set forth herein.

121. By virtue of their status as USSC shareholders, and by virtue of the unique relationship of trust and confidence engendered between defendant Scipione on behalf of USSC and William Chanoff, plaintiffs herein were owed fiduciary duties of care, loyalty, candor and fair dealing by USSC, by defendant Scipione, and by the remaining Individual Defendants, each of whom was and is an executive officer and director of USSC. Defendants were obligated to speak fully, honestly and truthfully with William Chanoff concerning USSC, not to mislead or deceive him or the other plaintiffs in any way, and not to put their own interests above the interests of plaintiffs.

122. From January 1, 1992, through April 14, 1993, defendants breached their fiduciary duties to plaintiffs herein by, among other things, making and causing to be made false statements, misleading statements, and forward-looking statements lacking any reasonable basis to plaintiffs, by suppressing and concealing material information from plaintiffs, and by taking advantage of their superior knowledge and information to sell large quantities of their USSC stock while inducing plaintiffs to retain their own USSC stock (and, in the

case of William Chanoff, to purchase additional shares), thereby greatly damaging plaintiffs.

COUNT IV: NEGLIGENT MISREPRESENTATION (Against All Defendants)

123. Plaintiffs repeat and reallege paragraphs 1-105 above as if fully set forth herein.

124. From January 1, 1992 through April 14, 1993, defendants made and caused to be made false and misleading statements concerning USSC to plaintiffs and failed to disclose material information concerning USSC to plaintiffs, knowing that plaintiffs would justifiably rely on their statements to make financial decisions concerning their USSC stock.

125. Defendants failed to exercise reasonable care and competence in their communications with defendants in that they failed to ascertain that the information they supplied to plaintiffs was false and misleading and did not have any reasonable basis for believing it to be true and complete.

126. Plaintiffs believed and justifiably relied on defendants' negligent misrepresentations, which induced them to refrain from selling or hedging any of their USSC stock (and, in William Chanoff's case, induced him to purchase 2000 additional shares on or about October 9, 1992), and, as a direct and proximate consequence of defendants' negligent misrepresentations, were greatly damaged.

COUNT V: NEGLIGENCE (Against All Defendants)

127. Plaintiffs repeat and reallege paragraphs 1-105 above as if fully set forth herein.

128. Defendants owed a duty to plaintiffs to exercise reasonable care and competence in their dealings with plaintiffs,

including all communications of material information concerning USSC.

129. Defendants knew or should have known, in the exercise of reasonable care and competence, that plaintiffs were relying on defendants to speak accurately and truthfully concerning USSC, and that plaintiffs would rely on defendants' communications to make financial decisions concerning their USSC stock.

130. Defendants failed to exercise reasonable care and competence in communicating material information to plaintiffs concerning USSC, thereby inducing plaintiffs to refrain, in reliance upon defendants' communications, from selling or hedging any of their USSC stock (and, in William Chanoff's case, inducing him, in reliance on defendants' communications, to purchase 2000 additional shares on or about October 9, 1992).

131. Plaintiffs acted with ordinary care and prudence in relying on defendants' communications in making financial decisions concerning their USSC stock and, as a direct and proximate consequence of defendants' negligence, have been greatly damaged.

132. Defendants knew or reasonably should have foreseen that plaintiffs would rely on their communications concerning USSC, would be induced thereby to refrain from selling or hedging any of their USSC stock (and, in William Chanoff's case, to purchase additional shares), and would be greatly damaged thereby.

COUNT VI: VIOLATION OF RULE 10b-5
(Against All Defendants)

133. Plaintiffs repeat and reallege paragraphs 1-105 above as if fully set forth herein.

134. From January 1, 1992, through April 14, 1993, defendants engaged in a plan, scheme, conspiracy and course of

conduct pursuant to which they knowingly or recklessly engaged in acts, transactions, practices and course of conduct which operated as a fraud and deceit upon William Chanoff in connection with his purchase of USSC securities, thereby violating Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5").

135. Between January 1, 1992, and April 14, 1993, defendants made and caused to be made, directly or indirectly, untrue statements of material fact concerning USSC to William Chanoff in connection with his purchase of USSC securities.

136. Between January 1, 1992, and April 14, 1993, defendants omitted to state material facts necessary to make the statements they made concerning USSC, in light of the circumstances under which they were made, not misleading, in connection with William Chanoff's purchase of USSC securities, thereby violating Rule 10b-5.

137. Between January 1, 1992, and April 14, 1993, defendants made and caused to be made, directly or indirectly, material representations concerning the future of USSC which lacked any reasonable basis in fact when made, and were not made in good faith, in connection with William Chanoff's purchase of USSC securities, thereby violating Rule 10b-5.

138. Between January 1, 1992, and April 14, 1993, defendants failed and omitted to state material information concerning USSC which they had a duty to disclose to William Chanoff and which a reasonable investor would require in order to make informed decisions concerning his or her USSC stock, in connection with William Chanoff's purchase of USSC securities, thereby violating Rule 10b-5.

139. Between January 1, 1992, and April 14, 1993, defendants employed devices, schemes and artifices to defraud in connection with William Chanoff's purchase of USSC securities, thereby violating Rule 10b-5.

140. Defendants acted willfully or at least recklessly in that they had actual knowledge or would have known, but for their reckless disregard of the truth, that their statements concerning USSC were false and/or misleading, had actual knowledge or would have known, but for their reckless disregard of the truth, of the omitted information necessary to make their statements not misleading, and had actual knowledge or would have known, but for their reckless disregard of the truth, that their representations concerning the future of USSC lacked any reasonable basis in fact and were not made in good faith.

141. Defendants' false statements, misleading statements, and forward-looking representations lacking any reasonable basis were intended to and did reach William Chanoff, either directly or through the media, and were believed and reasonably relied on by him. William Chanoff was ignorant of the false and misleading nature of defendants' statements.

142. Defendants' false statements, misleading statements, and forward-looking representations lacking any reasonable basis induced William Chanoff to purchase 2000 shares of USSC stock on or about October 9, 1992, at the artificially inflated price of almost $60.00 per share, and thereby damaged him greatly.

COUNT VII: RICO
(Against the Individual Defendants)

143. Plaintiffs repeat and reallege paragraphs 1-105 above as if fully set forth herein.

144. Each of the Individual Defendants was and is a person as that term is used in the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961 *et seq.*

145. USSC was and is an enterprise as that term is defined in 18 U.S.C. § 1961(4).

146. From January 1, 1992, through April 14, 1993, the Individual Defendants, all of whom were and are employed by and associated with USSC, conducted and participated in the affairs of USSC through a pattern of racketeering activity as those terms are defined in 18 U.S.C. §§ 1961(1) and 1961(4), thereby violating 18 U.S.C. § 1962(c). The pattern of racketeering activity consisted of, *inter alia*, numerous predicate acts of mail fraud indictable pursuant to 18 U.S.C. § 1341, wire fraud indictable pursuant to 18 U.S.C. § 1343, and fraud in the sale of securities cognizable pursuant to 15 U.S.C. § 78j(b) and SEC Rule 10b-5 promulgated thereunder.

147. From January 1, 1992, through April 14, 1993, the Individual Defendants planned and agreed with one another to engage in the predicate acts of mail fraud, wire fraud and fraud in the sale of securities alleged above and each took action in furtherance of the agreement, thereby violating 18 U.S.C. § 1962(d).

148. Plaintiffs have been injured in their business and property by reason of the Individual Defendants' violations of 18 U.S.C. §§ 1962(c) and 1962(d) and are therefore entitled, pursuant to 18 U.S.C. § 1964(c), to treble damages and their reasonable attorneys' fees incurred in prosecuting this action.

COUNT VIII: VIOLATION OF SECTION 36-472
(Against All Defendants)

149. Plaintiffs repeat and reallege paragraphs 1-105 above as if fully set forth herein.

150. Between January 1, 1992, and April 14, 1993, in connection with the offer, sale and purchase of USSC securities, defendants, directly or indirectly, knowingly or recklessly:

(a) employed devices, schemes, and artifices to defraud;

(b) made untrue statements of material facts and omitted to state material facts necessary to make the

statements made, in the light circumstances under which they were made, not misleading; and

(c) engaged in acts, practices and course of business which have operated as a fraud and deceit upon plaintiffs,

thereby violating Section 36-472 of the Connecticut Uniform Securities Act.

151. Plaintiffs were induced, by defendants' conduct to refrain from selling any of their USSC stock (and, in the case of William Chanoff, to purchase additional shares on or about October 9, 1992), and have been greatly damaged thereby.

WHEREFORE, plaintiffs demand judgment as follows:

A. On all counts, compensatory damages in an amount according to proof but believed to be in excess of $40 million.

B. On Counts I, II and III, punitive damages in an amount according to proof.

C. On Counts I, II and III, damages for emotional distress in an amount according to proof.

D. On Count VII, treble damages in an amount according to proof but believed to be in excess of $120 million, plus plaintiffs' reasonable attorneys' fees incurred in prosecuting this action.

E. Plaintiffs' costs and expenses of bringing suit herein; and

F. Such other and further relief as the Court deems just and proper.

DEMAND FOR JURY TRIAL

Plaintiffs demand a trial by jury.

Dated: July 30, 1993

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No. 94-755

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

WILLIAM CHANOFF, DAVID CHANOFF, RACHEL CHANOFF and HARRIET FINGEROTE,

Petitioners,

—v.—

UNITED STATES SURGICAL CORPORATION, LEON HIRSCH, TURI JOSEFSEN, BRUCE C. LUSTMAN and MARIANNE SCIPIONE,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

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November 18, 1994

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QUESTIONS PRESENTED

1. Should this Court grant *certiorari* to decide petitioners' first question, concerning whether their six state law claims were preempted by the anti-tippee norms of the federal securities laws, when both courts below also rested dismissal of each claim independently on one or more state law grounds?

2. Should this Court grant *certiorari* to decide the second question, challenging the state law holding (affirmed by both courts below) that the damages sought on the six state law claims are too speculative under Connecticut law, in view of the policy against this Court's review of state law claims and the fact that dismissal of those claims also rests on multiple independent and adequate state law grounds, including that the damages sought were not proximately caused by the wrong of which petitioners complain?

3. Should this Court grant *certiorari* to decide petitioners' third question, concerning whether the purchaser-seller rule of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), applies to civil RICO cases, when the dismissal of petitioners' RICO claims also rests on multiple independent grounds, including that petitioners, who neither bought nor sold securities during the period of the alleged wrong, (a) did not allege any injury that could be found proximately related to the alleged wrong as required by *Holmes v. Securities Investors Protection Corp.*, 112 S. Ct. 1311 (1992), (b) did not allege any non-speculative injury, (c) did not allege any facts constituting "fraud in the sale of securities" as required by 18 U.S.C. §1964(c), and (d) did not allege any cognizable injury to their property under the federal wire and mail fraud statutes?

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COUNTER-STATEMENT OF THE CASE

The case petitioners describe bears only a fleeting and fractured resemblance to the case presented in petitioners' complaint and argued to the district court. For present purposes, however, beyond noting that the "facts" petitioners recite are simply the untested allegations of their complaint assumed to be true under the familiar standard on a motion to dismiss pursuant to Rule 12(b)(6), Fed. R. Civ. P., it should suffice to supplement petitioners' statement of the case with three additional points.

At the heart of their complaint was the basic theory that "a unique relationship of truth and confidence existed between William Chanoff and defendants" (Cmplt. ¶ 116).[1] Thus, petitioners asserted that United States Surgical Corporation ("USSC") and the individual defendants (collectively, "respondents" or "defendants") knew that the information allegedly not disclosed was "of particular concern" to Chanoff (*id.*), that defendants had unique fiduciary duties "to speak fully . . . with William Chanoff concerning USSC" (¶ 121), and that defendants "suppressed and concealed" information from Chanoff personally in order to induce him and his family specifically to refrain "from selling or hedging any of their USSC stock" (¶ 117-18).[2] Petitioners' case was founded on

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[1] "Cmplt. ¶ _" refers to paragraphs of petitioners' complaint, reproduced in Appendix E of the petition for a writ of certiorari ("Pet."). "App. Br. _" refers to pages of Petitioners' brief in the Court of Appeals, and "A_" refers to pages of the Joint Appendix in that court.

[2] Among the allegations whose sole function was to support the claim that Chanoff was entitled to information on the telephone or in writing beyond what had been publicly disclosed were ¶¶ 1, 19, 46, 56, 66, 78-79, 100, 111, 116, 121. Those paragraphs allege the reasons why Chanoff was entitled to information not disclosed

(continued...)

the proposition that William Chanoff and his family were entitled to non-public information from USSC and its Vice President for Corporate Communications, Marianne Scipione, by virtue of his prior position as a director of USSC and continued effort to obtain unique information about the company. Thus, all petitioners' damage allegations presuppose that they would have sold upon receiving information in advance of any other shareholders. *E.g.*, ¶¶ 96(a), 97(a), 98(a), and 99(a).[3]

Further, although petitioners did allege that Chanoff was "asked" by "a stockbroker" to "consider" selling some or all of his stock (Cmplt. ¶ 84), they did not allege that Chanoff (or any other plaintiff) ever asked for Scipione's opinion or guidance as to whether or not he should sell or hedge his USSC holdings; ever informed Scipione that he or she was actually considering selling or hedging, or that his or her decision whether to do so would be based on information that Scipione provided; ever told Scipione that others (including petitioners here) were depending on Scipione's advice; or ever told Scipione that he or she believed he or she had a sufficient

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[2](...continued)
to the public, including that he was constantly fishing for inside information from "defendant Scipione, both by letter and by telephone, concerning various matters affecting the prospects of USSC and the value of its stock." Cmplt. ¶¶ 17-19. At oral argument, plaintiffs' counsel said, "I don't deny that those [the individual conversations that Chanoff had with Scipione] play an important role in our case. They do." A242.

[3] Petitioners do allege the proceeds that a hypothetical sale on January 15, 1992, at the height of the market for USSC stock, would have produced (*e.g.*, ¶¶ 96(a), 97(a), 98(a), and 99(a)), but carefully avoid alleging that they would have sold on that date at the height of the market had the company disclosed to them or to the public the allegedly undisclosed additional information it had as of that time.

relationship with Scipione or with USSC to be entitled to receive material nonpublic information denied to other investors. Cmplt. ¶¶ 46, 66-67, 74, 77-80, 84, 88.

Finally, petitioners alleged no facts concerning the dates on which they would have sold or hedged some or all of their shares had they known "the truth" earlier, much less the number of shares that each petitioner would have sold and/or hedged on particular dates during that sixteen-month period during which USSC's share price steadily dropped. Instead, each petitioner alleged only, to use the representative allegation of William Chanoff, that he or she "declined to sell or hedge any of his USSC stock, as he would have done had he known the truth, from January 1, 1992 until April 9, 1993." Cmplt. ¶¶ 96(a), 97(a), 98(a), and 99(a).[4]

REASONS FOR DENYING THE PETITION

The petition should be denied because the case does not fairly present any of the questions petitioners attempt to raise and does not warrant this Court's review.

Any answer this Court would give to petitioners' first question, concerning whether federal preemption principles barred their six state law claims, would be dicta. Each of those state law claims was also dismissed for one or more independent and adequate reasons under state law.

The second issue presented — concerning whether the damages sought by securities holders for alleged fraud, negligent misrepresentation, breach of fiduciary duty, or violation of a Connecticut securities anti-fraud statute, during a period when those holders neither bought nor sold securities, are unduly speculative — presents a question of

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[4] *See* n. 3 *supra*. Moreover, as the district court observed, "the plaintiffs conceded at oral argument [that] there is not one precise point at which the defendants' duty to disclose information attached . . . . " Pet. C-10.

Connecticut law. This Court does not deploy its discretionary jurisdiction to correct applications of state law. Doing so would be particularly unwise here, where the six state law claims were dismissed not only for unduly speculative damages but also, independently and adequately, on multiple additional state law grounds.

Although there is a federal issue lurking in the third question presented — concerning whether the rule announced in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), applies generally to RICO claims predicated on securities fraud — that question is not properly presented here and any answer provided would be dicta. As both courts below correctly held, the RICO claims pressed here were subject to dismissal under non-*Blue Chip Stamps* grounds, including the proximate cause ground relied on by this Court in *Holmes v. Securities Investors Protection Corp.*, 112 S. Ct. 1311 (1992). Review of those issues has not been sought and cannot be justified under the factors governing this Court's exercise of its discretionary jurisdiction, and in any event each of the grounds relied on for dismissal was plainly correct under long-settled law.[5]

I. PREEMPTION IS NOT PROPERLY AT ISSUE AND WAS CORRECTLY DECIDED

The district court held that the Chanoffs' six state law claims were preempted only to the extent that those claims

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[5] In their argument (although not in the Questions Presented), petitioners contend (at 9-25) that the courts below imposed the *Blue Chip Stamps* "standing" requirement on state law securities claims as a matter of federal law. That contention is wrong; the district court did not so much as mention *Blue Chip Stamps* in the portions of the decision dismissing the state law claims, and cited it for the first time only in the last section, addressing the federal claims. Pet. C-20.

rested on an alleged duty by USSC's Vice President for Corporate Communications "to disclose [nonpublic information] to William Chanoff during their personal exchanges." Pet. C-5-8. The court proceeded, however, to dismiss the state law claims in their entirety on multiple additional state law grounds:

- All six claims were dismissed because "plaintiffs, with limited exception, have not alleged cognizable injury or damage that could be construed as directly or proximately caused by the alleged misconduct as required to sustain the common law causes of action." Pet. C-8.[6]
- As an additional ground for dismissing the breach of fiduciary duty claim, the courts below held that, under state law, "plaintiffs lack standing to assert this claim because defendants owe no independent fiduciary duty to the plaintiffs. . . . . " Pet. C-13.
- The two negligence claims were dismissed "not only for failure to allege proximate injury but also for lack of standing." Connecticut law does not afford a remedy for negligent misstatement or omission to an indeterminate class in an indeterminate amount for an indeterminate time. Pet. C-17-18.
- As an additional ground for dismissing the statutory state law securities claim, the courts held that the statute provided no private right of action. Pet. C-18-19.

Under these circumstances, anything this Court would say about preemption would be dicta.

In any event, both courts below correctly concluded that "to the extent that plaintiffs' state law claims are based on

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[6] The "exception" refers to the claim of William Chanoff concerning a purchase of 2,000 shares, which has been voluntarily dismissed from this action and is not before this Court. *See* Pet. 8 n. 7.

defendant Scipione's failure to disclose certain information to Chanoff during their personal exchanges, these claims are preempted by the federal securities laws which proscribe such selective disclosure." Pet. C-5-6; *see also Basic, Inc. v. Levinson*, 485 U.S. 224, 242 (1988); *Dirks v. SEC*, 463 U.S. 646, 659-60 (1983); and *Chiarella v. United States*, 445 U.S. 222, 228 (1980).[7]

II. THE STATE LAW SPECULATIVE DAMAGE ISSUE DOES NOT WARRANT REVIEW AND WAS CORRECTLY DECIDED

The holding of both courts below that under Connecticut law the damages sought on all six state law claims were too speculative to be litigated (Pet. C-8-19) does not merit review. This Court does not use its *certiorari* jurisdiction to review determinations of state law, especially when both the district court and court of appeals agreed in such a determination. *Haring v. Prosise*, 462 U.S. 306, 314 n. 8 (1983); *Brockett v. Spokane Arcades, Inc.*, 472 U.S. 491, 499-500 (1985); *Butner v. United States*, 440 U.S. 48, 57-58 (1979); Robert L. Stern et al., *Supreme Court Practice* 183 (7th ed. 1993).

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[7] *See also Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165, 169 (2d Cir. 1980) (the "duty imposed on a company and its officers is an alternative one: they must disclose material inside information either to no outsiders or to all outsiders"); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) ("The only regulatory objective is that access to material information be enjoyed equally"); and *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 1961 WL 3743, at *6 (Nov. 8, 1961) (trading on information obtained in advance of the rest of the market is forbidden "until the established procedures for public release of the information are carried out . . .").

Even if the ruling that the damages sought are unobtainable under Connecticut law were a proper subject for this Court's review, *certiorari* should still be denied, as the dismissal of the six state law claims rested as well on the independent proximate cause and other grounds identified above (at page 5) on which petitioners have not sought review.

The holding precluding the damages sought as impermissibly speculative was in any event so evidently correct as not to warrant this Court's review. Under Connecticut law, "a plaintiff cannot recover profits which might have been realized if he had not been deceived, unless there is evidence by which such profits can be estimated with reasonable certainty." Pet. C-9-10 (relying on *Morrell v. Wiley*, 178 A. 121, 123 (Conn. 1935), and *Pacelli Bros. Transp., Inc. v. Pacelli*, 456 A.2d 325 (Conn. 1983)).

Petitioners' complaint sought as damages the difference between the "unmanipulated" market price at which "the Chanoffs *could have sold their USSC shares* - had respondents promptly and publicly disclosed truthful information . . . and the approximately $30 per share with which they were left, in April, 1993, after defendants belatedly told the truth." (Pet. 21, emphasis added).

These damages are doubly speculative. First, as petitioners' use of the phrase "could have sold" (instead of "*would* have sold") betrays, it is uncertain — and ascertainable at best only by uncorroboratable oral testimony — whether petitioners were damaged at all. (Petitioners, by their own premises, acquired their shares before any alleged fraud-induced price increase; if they would have retained those shares past the time that the price dropped in response

to market disclosure, then they did not lose anything to which they were entitled.)[8]

Second, even on the dubious assumption that the Chanoffs lost something (other than the opportunity to profit from a price their own complaint alleges was unlawful), their alleged market losses are speculative on at least six levels. Petitioners did not allege *any* of the fixed points necessary for a damage calculation: (i) the date on which defendants should have made the allegedly omitted disclosures; (ii) the date(s) (if any) on which plaintiffs would have changed their previously steadfast policy of holding their USSC stock, which they notably maintained for well over a year despite a steadily dropping price, and sold and/or hedged their holdings; (iii) the "unmanipulated" market price of their USSC holdings on the date or dates they would have sold or hedged, which by petitioners' own premises would have involved speculation regarding the actions that would have been taken by thousands of other holders of USSC stock; (iv) the number of shares (if any) they would have sold on that date or those dates; (v) the number of shares (if any) they would have hedged on that date or those dates; and (vi) the extent to which the decline in USSC's stock price, from when they would have sold until April 7, 1993, was attributable to factors other than the alleged fraud.[9]

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[8] *See Crocker v. Federal Deposit Ins. Corp.*, 826 F.2d 347 (5th Cir. 1987), *cert. denied*, 485 U.S. 905 (1988) (plaintiffs who purchase at unmanipulated price are not entitled to profit from the price to which shares are subsequently manipulated by fraud).

[9] Petitioners conceded that they would have to prove that "they would have sold their USSC stock on the open market upon learning of the JIT program" to be entitled to damages. App. Br. 28. Any attempt to do so would have been problematic, in light of the rather different allegation that Chanoff would have sold *or* (continued...)

In the ordinary 10b-5 case, such as those on which petitioners rely (Pet. 22), the dates and sizes of purchases or sales of not only the plaintiffs but also all investors in the issuer's stock are fixed, and all that needs be reconstructed is an unmanipulated share price on the date of trade. *See, e.g., Minpeco, S.A. v. Conticommodity Servs., Inc.*, 676 F. Supp. 486, 495 (S.D.N.Y. 1987); *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 576-78 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982). The case-authorized damage models for such circumstances do not require speculation about what investors in the issuer's stock who did not buy or sell during the damage period would have in fact done if the alleged undisclosed information had been available to all the issuer's stockholders.

By contrast, the problem posed by petitioners' holder claims is not merely the limited uncertainty of ordinary 10b-5 cases, requiring only the reconstruction by expert testimony of an "unmanipulated" value on a fixed date, but a far more impenetrable thicket of speculation and doubt. Most importantly, it is wholly speculative whether, when, and how

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[9](...continued)

hedged all, *or some*, of his stock (Cmplt. ¶¶ 84, 96(a)), and counsel's concession at oral argument in the district court that Chanoff "never had any intention of selling his U.S. Surgical stock." A260; *see also* A254 ("we do contend that our clients would have *been able* to sell their stock or at least to hedge it at a price which reflected the market's evaluation and analysis . . .") (emphasis added). These vague and conflicting formulations directly implicate the concerns expressed in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), strongly reaffirmed in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), about the integrity of the judicial process and the hydraulic pressures that holder claims would impose on plaintiffs to provide false oral testimony in circumstances where no corroboration is likely to be available.

many shares petitioners would have sold or hedged; and it is equally speculative whether, when, and how all the thousands of other holders of USSC shares would have sold or hedged. Based on the answers provided to those key questions, experts would have had to reconstruct prices for each such date of selling or hedging, as well as determine what part of the subsequent steady drop to April 7 was attributable to the alleged fraud.

As both courts below saw, these additional undeterminable factors (which the petition ignores) place resolution of petitioners' unpreempted state law claims in the domain of dart-throwing or fortune-telling, and well outside the domain established by Connecticut for the reasonable ascertainment of damages under law. Permitting a jury to award damages in such a case would offend every policy underlying the traditional judicial refusal to allow lost profits except where they can be estimated with reasonable certainty.[10]

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[10] Permitting jury awards in those circumstances would also offend the policies relied on by eight members of this Court in *Virginia Bankshares*, policies of such compelling nature that there is no reason to doubt that they would move most state courts as well. As Justice Souter wrote for the Court (501 U.S. at 1092),

> Recognizing liability to merely would-be investors [or sellers], however, would have exposed the courts to litigation unconstrained by any [] anchor in demonstrable fact, resting instead on a plaintiff's "subjective hypothesis" about the number of shares he would have sold . . . . Hindsight's natural temptation to hypothesize boldness would have magnified the risk of nuisance litigation, which would have been compounded both by the opportunity to prolong discovery, and by the capacity of claims resting on undocumented personal assertion to resist any resolution short of settlement or trial. Such were the premises of policy . . . on which Blue Chip Stamps deflected the threat of

(continued...)

Petitioners attempted to eliminate some of this uncertainty by telling the Second Circuit that they would have done better than other investors if the requisite information had been given to both William Chanoff and the public generally. App. Br. 17-18. By their own hypothesis, however, the price would have dropped upon public disclosure to its "unmanipulated" level (wringing out of the stock price the claimed inflated value which they conceded no investor may properly claim) (App. Br. 18 n.9); and the very premise of the fraud-on-the-market theory on which modern securities litigation is largely based is that upon earlier public disclosure the price would have dropped in the same manner that it did when USSC made its April 7 announcement. It would therefore be purely undisciplined speculation to conclude that petitioners, or any other investor, could get out faster than the analysts, market professionals, or others as the market promptly absorbed the bad news. A jury would have no means but guesswork or prejudice to make such assessments.[11] And

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[10](...continued)

> vexatious litigation over "many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony." [*Blue Chip Stamps*, 421 U.S.] at 743.

[11] As the Fifth Circuit saw in similar circumstances,

> The flaw in the [plaintiffs'] argument is that . . . had this information been released, the stock price would have immediately and precipitously fallen especially if, as is implicit in the Crockers' theory, an entire class of shareholders had simultaneously dumped their stock on the market. Thus, there would have been no market for the stock at the artificially high price. Without such a market, the [plaintiffs'] envisioned "profit opportunity" evaporates into hardly more than an illusion.

Crocker v. FDIC, 826 F.2d at 351-52.

the wrong cannot be viewed as the failure to say "no comment" (leaving Chanoff no better off than shareholders generally), as doing so causes an insuperable proximate cause problem: the failure to say "no comment" was clearly not the proximate cause of petitioners' losses.[12]

III. THE *BLUE CHIP STAMPS* ISSUE IS NOT PROPERLY PRESENTED, AS DISMISSAL OF THE RICO CLAIMS WAS CORRECT ON GROUNDS NOT WARRANTING REVIEW

Dismissal of the RICO claims rested on multiple grounds, and this case is no better vehicle than was *Holmes v. Securities Investors Protection Corp.* for deciding whether the *Blue Chip Stamps* rule generally applies to RICO cases based on predicate acts of securities fraud.

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[12] Petitioners do not allege that they would have sold their shares had Scipione simply answered "no comment" and referred Chanoff to the public record. Far from alleging any fixed intention to sell that was undermined by the asserted personal misrepresentations, petitioners conceded that because of the appreciation of 400,000 shares acquired many years previously, Chanoff had developed the fixed intention to retain based on public disclosures. A260 ("Mr. Chanoff never had any intention of selling his U.S. Surgical stock. It was his intention to hold that stock for long-term appreciation and have it become part of his estate"). *Cf. Goldman v. Feinberg*, 37 A.2d 355, 356 (Conn. 1944) (to obtain tort damages for lost profits, plaintiff must "show that he was not only 'about to,' but would, but for the malicious interference of the defendants, have entered into the contract . . .").

Of course, petitioners cannot eliminate uncertainty from their damage calculations by contending that the wrong was only the failure to provide information selectively to William Chanoff, rather than the failure to provide that information to the market generally, since doing so would have violated compelling and controlling federal norms against such conduct.

First, the remaining RICO claims were properly dismissed because petitioners failed to allege any injury to their "business or property" proximately caused by defendants' conduct, as required by 18 U.S.C. § 1964(c) (1984). They lost no shares, their ability to sell their shares was never impaired, and they lost no money to which they were entitled (*see* n. 8 *supra*), having neither bought at an artificially inflated price nor sold at an improperly deflated price. In this context, hypothetical lost profits are not a cognizable property interest for purposes of defining a RICO wire or mail fraud predicate felony. *United States v. Miller*, 997 F.2d 1010 (2d Cir. 1993).

Second, following the approach of *Holmes v. Securities Investors Protection Corp.*, 112 S. Ct. 1311 (1992), which avoided the purchaser-seller issue by analyzing plaintiffs' claims under traditional proximate cause principles, the district court held that plaintiffs failed to allege any non-speculative damages that could be found proximately caused by the alleged RICO violation. Pet. C-22-24; *see also, e.g., Lewis v. Robinson*, No. 94-7131, 1994 U.S. App. LEXIS 30514 (2d Cir. Nov. 1, 1994) (affirming dismissal for lack of proximate causation); *Commercial Union Assurance Co. Plc v. Milken*, 17 F.3d 608 (2d Cir. 1994) (case dismissed on summary judgment, as plaintiffs could not show compensatory damage); *Hecht v. Commerce Clearing House, Inc.*, 897 F.2d 21, 22 (2d Cir. 1990) (Rule 12(b)(6) dismissal where damages not proximately caused by alleged RICO violation); *Barrows v. Forest Labs., Inc.*, 742 F.2d 54, 60 (2d Cir. 1984) (dismissing securities fraud claims based on speculativeness of damages).[13]

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[13] *See also Fleischhauer v. Feltner*, 879 F.2d 1290, 1300 (6th Cir. 1989), *cert. denied*, 494 U.S. 1027 (1990) ("[t]he conduct of the defendants . . . caused the parties to invest in the films but it did

(continued...)

Third, at least for cases such as this, the plain statutory language of RICO compels a transactional connection between the alleged fraud and a sale of securities. Where securities fraud is alleged as a predicate act, "The statute unmistakably requires that there be fraud, sufficiently willful to constitute a criminal violation, *and that there be a sale of securities.*" *See Holmes*, 112 S. Ct. at 1325 (O'Connor, J., concurring) (emphasis added); *see also Blue Chip Stamps*, 421 U.S. at 731-36 (*Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S.956 (1952) purchaser-seller limitation is supported by statutory language of § 10(b), 15 U.S.C. § 78j(b) (1994), prohibiting fraud only "in connection with the purchase or sale of any security" and not otherwise). In *Holmes*, although the SIPC, as a stand-in for the insolvent securities firm, had not actually been the purchaser, the insolvent firm was clearly injured by fraud *in the sale of securities*. Here, by contrast, not only did petitioners not sell their securities, but also they were not harmed by alleged fraud in the sale of securities.[14]

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[13](...continued)
not cause the investment items to become less profitable than defendants represented . . ."); *In re American Express Co. Shareholder Litig.*, 840 F. Supp. 260 (S.D.N.Y. 1993) (an employee's loss of commissions may have been factually, but were not proximately, caused by defendants' RICO violations), *aff'd sub nom. Lewis v. Robinson*, No. 94-7131, 1994 U.S. App. LEXIS 30514, at *23-24 (2d Cir. Nov. 1, 1994).

[14] Justice O'Connor's concurring opinion in *Holmes* addressed the somewhat different question concerning standing. The standing issue in *Holmes* was whether the SIPC, which had never held or traded the relevant shares but was suing under a subrogation theory, could sue under § 1964(c), which limits standing to "any person injured in his business or property." The "plain statutory language" reasons Justice O'Connor gave for not superimposing the
(continued...)

Nor can petitioners rely on the respondents' alleged sales of their own USSC stock into the market to establish the necessary predicate acts of "fraud in the sale of securities." Petitioners have not been "injured in [their] business or property by reason of" respondents' alleged predicate acts of "fraud in the sale of securities,"[15] as petitioners did not trade contemporaneously with any of the defendants. *See* Pet. C-16 n.10.

Even if the RICO claims had been dismissed under the sole authority of *Blue Chip Stamps*, review would not be warranted, as the *Blue Chip Stamps* rule should be applied in cases like this, either to require that plaintiffs have purchased

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[14](...continued)

Blue Chip Stamps purchaser or seller limitation onto the standing requirement of § 1964(c) are inapposite here, where the question is not one of standing but rather whether petitioners have alleged racketeering activity concerning "fraud in the sale of securities" under the § 1961(1) definition of "racketeering activity." Any injury petitioners here can complain of is not caused, as it was in *Holmes*, by fraud "in the sale of securities." *See* 112 S. Ct. at 1315.

Justice O'Connor went on to consider another question not presented here, whether a "purchaser/seller" standing limitation could be justified under the definition of "racketeering activity" in § 1961(1), and concluded that "the predicate offense does not *necessarily* dictate that a RICO plaintiff have been a party to an executed sale." 112 S. Ct. at 1325 (emphasis in original). But the concurrence does not suggest that a RICO claim may be pleaded where, as here, plaintiffs are neither parties to a sale nor have themselves been harmed by fraud in the sale of securities. To the contrary, Justice O'Connor's analysis expressly required a sale as an element of the statute.

[15] *See also Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 497 (1985); *American Nat'l Bank & Trust Co. v. Haroco, Inc.*, 473 U.S. 606, 609 (1985); *Fleischhauer v. Feltner*, 879 F.2d at 1300.

or sold, or at least to the extent of requiring that plaintiffs have been injured by fraud in the sale of securities. *See International Data Bank, Ltd. v. Zepkin*, 812 F.2d 149, 152-53 (4th Cir. 1987) (RICO plaintiff relying on securities fraud as predicate offense must have been purchaser or seller); *Brannan v. Eisenstein*, 804 F.2d 1041, 1046 (8th Cir. 1986) (same).[16]

Setting RICO claims based on securities fraud allegations adrift from *Blue Chip Stamps* would be tantamount to jettisoning that case altogether. Because virtually every Rule 10b-5 lawsuit arising from misrepresentations and omissions

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[16] *See also Powers v. British Vita P.L.C.*, 842 F. Supp. 1573, 1583 (S.D.N.Y. 1994) (non-purchaser of securities did not have standing to advance a Rule 10b-5 securities fraud claim under RICO); *Viacom Int'l Inc. v. Icahn*, 747 F. Supp. 205, 210 (S.D.N.Y. 1990), *aff'd*, 946 F.2d 998 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1244 (1992) ("[p]laintiff must have been directly involved in either the purchase or sale of the securities in the Rule 10b-5 allegations to have standing under RICO to assert a Rule 10b-5 violation as a predicate act of racketeering . . ."); *In re Par Pharmaceutical, Inc. Secs. Litig.*, 733 F. Supp. 668, 684 (S.D.N.Y. 1990) ("[F]raud in the Sale of Securities" as used in RICO § 1961(1)(D) applies only if fraud occurred in the actual sale, as opposed to the purchase, of securities); *Beres v. Thomson McKinnon Secs., Inc.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,722, at 98,402 (S.D.N.Y. Dec. 20, 1990) (court dismissed plaintiff's RICO securities fraud claim because the plaintiff neither purchased nor sold securities); *Chief Consol. Mining Co. v. Sunshine Mining Co.*, 725 F. Supp. 1191, 1194 (D. Utah 1989) ("private persons have standing to bring RICO claims based on securities violations under Rule 10b-5 only if they are purchasers or sellers of securities . . ."); *Kravetz v. Brukenfeld*, 591 F. Supp. 1383, 1390 (S.D.N.Y. 1984) (a RICO securities fraud claim predicated on a Rule 10b-5 violation requires fraud in the sale of securities). *Contra, Pelletier v. Zweifel*, 921 F.2d 1465, 1510-11 n.80 (11th Cir.), *cert. denied*, 112 S. Ct. 167 (1991); *Warner v. Alexander Grant & Co.*, 828 F.2d 1528, 1530 (11th Cir. 1987).

can be augmented with RICO claims based on the same facts, accepting petitioners' argument would, to paraphrase *Ultramares Corp. v. Touche*, 255 N.Y. 170, 186-87 (1931), render the carefully considered holding in *Blue Chip Stamps* nothing but a

> snare, entrapping litigants and lawyers into an abandonment of the true remedy lying ready to the call. The suitors thrown out of court because they proved [securities fraud], and nothing else, in an action [under Rule 10b-5], might have ridden to triumphant victory if they had proved the self-same facts, but had given the wrong another label [RICO] . . . .

It would be illogical in the extreme to find the dangers identified by this Court in *Blue Chip Stamps* and *Virginia Bankshares* so substantial that mere holders may not bring suits for even actual damages, while at the same time totally to disregard those same dangers (and indeed augment them) in cases based on the same facts by exposing those same defendants and courts to RICO suits for *treble* damages. Such a result should not be adopted unless RICO's statutory language leaves no alternative. *Cf. Virginia Bankshares*, 501 U.S. at 1106 ("[g]iven a choice we would reject any theory . . . that raised such prospects [those identified in *Blue Chip Stamps*], and we reject this one . . .").

In light of the statutory reference in 18 U.S.C. § 1964(c) to fraud "in the sale of securities," and legislative history making plain that the "evil" at which 18 U.S.C. § 1964(c) was aimed was not assertions of inaccuracy in routine corporate disclosures but rather so-called "boiler-room broker-dealer operation"[17] and efforts by organized crime

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[17] The "boiler-room broker-dealer operation," which first drew attention in the late 1960's, refers to high-pressure operations (continued...)

illegally to gain control of brokerage firms and then use that position either to sell fraudulent stock or manipulate prices by purchasing controlling interests in closely held corporations,[18] there is compelling reason not to read RICO as eviscerating the salutary policies of *Blue Chip Stamps*.

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[17](...continued)
selling highly speculative or worthless securities of issuers without substantial businesses, *see, e.g., Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969); *United States v. Goldberg*, 401 F.2d 644, 647 (2d Cir. 1968), *cert. denied*, 393 U.S. 1099 (1969), and to the theft of securities and their later resale by organized crime, often resulting from pressure on back-room employees of brokerage houses and other institutions in the Wall Street area to repay loans made to them by organized crime or to repay gambling debts. *See The Federal Effort Against Organized Crime: Hearings Before a Subcommittee of the House Committee on Government Operations*, 90th Cong., 2d Sess. 325 (1968) (hereafter "*Federal Effort Hearings*") (statement of Irving M. Pollack, Director, Division of Trading and Markets, SEC); 115 Cong. Rec. 7607-08 (1969)(article by Patrick Young, included in statement of Rep. John M. Murphy).

[18] *See Federal Effort Hearings*, at 455; 113 Cong. Rec. 17,998 (1967) (statement of Sen. Hruska).

CONCLUSION

For all the foregoing reasons, the petition for a writ of *certiorari* should be denied.

New York, New York
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Respectfully submitted,

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